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TAX REFORM ACT OF 1986, PART 1

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

JANUARY 29 AND 30, 1986

(ECONOMIC IMPACT OF H.R. 3838)

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CONTENTS

PUBLIC WITNESSES

Page
Chimerine, Lawrence, Ph.D., chairman and chief economist, Chase Econometrics 18
Chase Econometrics, Lawrence Chimerine, Ph.D., chairman and chief economist 18
Brinner, Roger E., Ph.D., chief economist and group vice president, Data Resources, Inc 58
Data Resources, Inc., Roger E. Brinner, Ph.D., chief economist and group vice president 58
Schink, George, Ph.D., vice president for research and development, Wharton Econometric Forecasting Associates, Inc 76
Wharton Econometric Forecasting Associates, Inc., George Schink, Ph.D., vice president for research and development 76
Greenspan, Dr. Alan, president, Townsend-Greenspan & Co., Inc 156
Townsend-Greenspan & Co., Inc., Dr. Alan Greenspan, president 156
Weidenbaum, Dr. Murray, director, Center for Study of American Business, Washington University 165
Roberts, Dr. Paul Craig, professor of political economy, Center for Strategic and International Studies, Georgetown University 180

ADDITIONAL INFORMATION

Committee press release 1
Opening statement of Senator Max Baucus 2
Prepared statement of Senator George J. Mitchell 11
Prepared statement of Lawrence Chimerine, Ph.D 22
Prepared statement of Dr. Roger E. Brinner 61
Prepared statement of George R. Schink 79
Prepared statement of Dr. Alan Greenspan 159
Prepared statement of Murray L. Weidenbaum 167
Prepared statement of Paul Craig Roberts 184

COMMUNICATIONS

Tax Reform Action Coalition 243

TAX REFORM ACT OF 1986

WEDNESDAY, JANUARY 29, 1986

U.S. Senate,
Committee on Finance,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Chafee, Heinz, Wallop, Armstrong, Symms, Grassley, Long, Bentsen, Moynihan, Baucus, Boren, Bradley, Mitchell, and Pryor.

[The press release announcing the hearing and the prepared statements of Senators Baucus and Mitchell follow:]

[Press Release No. 86-001]

Committee on Finance Sets Hearings on Tax Reform

Five days of hearings on H.R. 3838, the Tax Reform Act of 1986, have been scheduled for the first two weeks of the second session of the 99th Congress, Chairman Bob Packwood (R-Oregon) announced today.

Senator Packwood said the hearings are set for January 29 and 30, and February 4, 5, and 6.

The principal purpose of the hearings is to examine the economic effects of H.R. 3838, on international competitiveness and capital formation. Senator Packwood said the Committee would invite several prominent economists to testify on this topic.

The hearings also will cover certain new subjects included in H.R. 3838, but not proposed by the Reagan Administration last year. Public witnesses will be scheduled to testify on these matters, Senator Packwood said. Senator Packwood chaired 23 hearings addressing tax reform issues between May 9 and October 10, 1985, receiving testimony from over 300 witnesses. He indicated these 1986 hearings would not cover subjects addressed at the 1985 hearings. Public witnesses will be strictly limited.

All of the hearings will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building in Washington, with Senator Packwood presiding.

STATEMENT BY SENATOR MAX BAUCUS
BPA VARIABLE RATE HEARING

COLUMBIA FALLS, MONTANA
JANUARY 29, 1986

MR. RADCLIFF, I AM VERY PLEASED TO BE HERE THIS EVENING.

IT'S BEEN ALMOST A YEAR SINCE YOU LAST CAME TO COLUMBIA FALLS FOR A HEARING ON BPA'S DRAFT OPTION STUDY.

OVER 3,400 PEOPLE FROM ALL ACROSS THE VALLEY CROWDED INTO THIS GYMNASIUM FOR THAT HEARING. THEIR SHOW OF SUPPORT FOR THE COLUMBIA FALLS PLANT WAS, IN A WORD, OVERWHELMING.

(AD LIB) FROM THE LOOKS OF THE AUDIENCE HERE TONIGHT, IT'S CLEAR THAT THAT SUPPORT IS STILL VERY STRONG.

LAST SPRING, NO ONE KNEW WHAT THE FUTURE WOULD HOLD. WE WERE WORRIED. IN FACT, MANY OF US WERE DOWNRIGHT SCARED THAT A MAJOR, SOLID INDUSTRY THAT HAD ECONOMICALLY SUPPORTED THE VALLEY FOR SEVERAL DECADES WAS FACING POSSIBLE COLLAPSE.

IN THE MONTHS THAT FOLLOWED, THE MONTANA CONGRESSIONAL DELEGATION, THE GOVERNOR, PLANT EMPLOYEES, MANAGEMENT, AND MOST OF ALL, MONTANANS IN THE FLATHEAD VALLEY BANDED TOGETHER TO BEGIN EXPLORING WAYS TO KEEP THE PLANT OPEN.

HURDLES OVERCOME

SOMETHING EXCITING HAPPENED! TOGETHER, WE OVERCAME WHAT AT TIMES LOOKED LIKE IMPOSSIBLE HURDLES:

o WE FOUND A BUYER FOR THE ARCO PLANT IN BRACK DUKER AND HIS EMPLOYEE-OWNED CORPORATION.

o WITH THE GOVERNOR'S LEADERSHIP, THE STATE BOARD OF INVESTMENTS PROVIDED $8 MILLION IN OPERATING CAPITAL FOR THE PLANT.

o The unions representing the plant's employees negotiated a labor agreement that would keep the plant viable.

o Plant management renegotiated its contracts with Burlington Northern to help bring transportation costs down.

In a word, we've come a long way since last spring. And the ones who deserve much of the credit are the people here in Columbia Falls and across the Flathead Valley.

The residents of this valley have shown a unswerving commitment to maintaining a viable aluminum industry in the Northwest.

HURDLES LEFT TO OVERCOME

But there are still three major hurdles left to cross. And BPA plays a critical role in determining whether we are successful.

HURDLE #1

The first hurdle is reducing the cost of electricity, which accounts for one-third of the plant's operating costs, in a timely manner.

?

BPA's final study recommends implementing a variable rate, which would tie the price of electricity to the price of aluminum.

BPA must implement this variable rate as soon as possible.

Under the current timetable, BPA is aiming to implement the variable rate by July or August. That may be too late to help the plant get the contracts it needs to survive.

The implementation date should be May 1.

If BPA waits until July or August, there effectively will not be any rate relief for the plant until March 1987.

The reason: BPA's seasonality pricing. Under this pricing scheme, BPA would charge a low rate

OF 13.8 MILLS IN MARCH THROUGH JULY. THAT'S A PRICE THE PLANT CAN LIVE WITH.

BUT FROM AUGUST TO FEBRUARY, BPA WOULD SWITCH TO A HIGHER RATE -- 19 MILLS. THE PLANT CAN'T SUSTAIN THIS HIGH PRICE.

IF BPA DOES NOT IMPLEMENT A VARIABLE RATE BY MAY 1, THEN BPA MUST DROP ITS SEASONALITY PRICING. I SUGGEST THAT BPA INSTEAD DESIGNATE THE RATE TO BE 16.7 MILLS, WHICH IS THE ANNUALIZED AVERAGE OF THE VARIABLE RATE.

HURDLE #2

THE SECOND HURDLE WE FACE IS ENSURING THAT THE ALUMINUM PRICE BPA USES TO SET ITS VARIABLE RATE IS BASED ON THE FUTURE PRICE OF ALUMINUM AS QUOTED BY THE LONDON METALS EXCHANGE.

CURRENTLY, BPA PLANS TO USE A FIVE-YEAR, ROLLING HISTORICAL AVERAGE OF ALUMINUM PRICES AS REPORTED BY METALS WEEK.

Columbia Falls plant officials have assured me that the most sensible and realistic price index to use is the future price, not the historical price.

HURDLE #3

The third hurdle we face is an even more immediate problem.

The plant is currently receiving an incentive rate from BPA. This rate was negotiated when ARCO was still owner of the plant. Under the terms of that contract, the incentive rate will expire March 31.

If this happens, rates will immediately rise to 22.8 mills. That will cost the plant an additional $1.5 million.

Yesterday, BPA announced that it would agree to defer a portion of the plant's power bills for April, May and June.

I AM ENCOURAGED BY BPA'S WILLINGNESS TO ADDRESS THE SHORT-TERM RATE PROBLEM. BUT I AM DISAPPOINTED WITH THE PLAN BPA HAS OFFERED.

THE TERMS OF THE PLAN ARE SIMPLY NOT ACCEPTABLE. THE INTEREST RATE ON THE DEFERRED AMOUNT WOULD BE 18 PERCENT ON AN ANNUAL BASIS. THAT'S JUST TOO HIGH.

BPA MUST COME UP WITH A BETTER, MORE REALISTIC SOLUTION. THE PLANT DESPERATELY NEEDS A FINANCIAL ARRANGEMENT TO TIDE THEM OVER UNTIL THE VARIABLE RATE IS IN PLACE. BUT THE ARRANGEMENT MUST BE ONE THAT THE PLANT CAN LIVE WITH.

CONCLUSION

WE'VE ALL WORKED SO HARD TO GET THIS FAR. WE MUST NOT STOP NOW.

THIS IS NOT JUST ANOTHER RATE CASE.

BPA WAS CREATED TO KNIT THE PEOPLE LIVING IN THE COLUMBIA RIVER DRAINAGE AREA INTO A COHESIVE ECONOMIC FAMILY.

The people of Columbia Falls and the Flathead Valley want to continue to be a part of this family.

The residents of this valley have shown a commitment to maintaining a viable industry in the Northwest. It's now up to BPA to hold up to its end of that commitment.

I was encouraged that last week Peter Johnson asked the Environmental Protection Agency to streamline the time period of its review of a draft environmental impact statement. I, along with the other Senators in the Northwest, wrote a letter in support of Mr. Johnson's request.

Happily, EPA agreed to shorten its 60-day comment period to 21 days for the draft EIS. EPA also tentatively agreed to reduce the final environmental review time to 15 days.

I urge each of you at this hearing to continue to fight hard. Write BPA. Write the Federal Energy Regulatory Commission and urge the commission to speed up its review timetable.

THE FERC HAS THE AUTHORITY TO GRANT IMMEDIATE INTERIM APPROVAL OF THE VARIABLE RATE, SUBJECT TO FINAL REFUNDING. HOWEVER, FERC WILL NOT EXERCISE THIS AUTHORITY UNLESS IT FULLY APPRECIATES THE EMERGENCY NATURE OF THIS SITIUATION.

IF WE ALL WORK TOGETHER, IN THE SPIRIT OF COOPERATION, I AM CONFIDENT WE CAN CLEAR THESE FINAL HURDLES.

TOGETHER, I KNOW WE WILL SUCCEED.

THANK YOU.

STATEMENT OF SENATOR GEORGE J. MITCHELL

TAX REFORM HEARINGS BEFORE THE SENATE COMMITTEE ON FINANCE

JANUARY 30, 1986

Mr. Chairman,

This Committee has a rare, once in a generation opportunity to enact fundamental tax reform legislation that will reduce individual and corporate tax rates, restore fairness to the tax system, and promote economic growth.

The House of Representatives made a good start. The House bill is not a perfect document; it is not the pure tax reform that many people envisioned when this long process began. It is a complex document in need of many revisions.

But the basic approach it takes is fundamentally sound-to replace inefficient, distorting tax subsidies with low marginal tax rates on corporations and individuals.

The House is to be commended for approving a pro-growth tax reform bill that removes over 6 million low income individuals and families from the tax rolls while increasing the standard deduction and personal exemption to give needed relief to working families. These changes have been accomplished while preserving the current distribution of tax burdens and maintaining the deduction for state and local taxes. In fact for taxpayers in many states, the House bill creates lower marginal tax rates than those requested by the Administration.

The House bill also includes a tough new minimum tax that will ensure that all taxpayers with substantial economic income will pay their fair share in taxes. Meanwhile incentives for research and development and capital investment are preserved at reasonable levels that will stop the inefficient distortions of investment decisions caused by unequal tax subsidies.

These are the minimum objectives that must be included in a Senate bill if we are to enact true tax reform in this nation.

There are skeptics who believe this Committee will fail in its efforts; that we will yield to those who can construct compelling reasons why it is crucial the this nations economic future that they continue to pay little or no taxes.

There has been speculation that the Committee will preserve current tax subsidies through new, regressive takes burdens on individuals. Others have suggested repealing the deduction for state and local taxes as a means of restoring tax breaks for the corporate community.

Those options are unacceptable to me, I hope, after we have had an opportunity to fully explore these alternatives, the Committee will reject them.

The Members of the Committee are understandably concerned about the effect that tax reform will have on the ability of U.S. industry to compete internationally. That is a concern that I share. However, we should not be mailed by those who will use this issue to justify their continuing avoidance of federal tax liability.

In 1981, this Committee was heavily influenced by those who painted vivid pictures of the effect the President's tax program would have on productive investment and savings. The result has been just the opposite of what was predicted. fixed business investment is no higher than it was in 1981 and the personal savings rate is at the lowest level ever.

Over the next week we will hear from many witnesses. I look forward to their testimony, but we should be cautious about anyone's ability to predict the future course of the economy in the wake of the structural changes in tax reform. That is especially true if we reflect on the inaccuracy of most of the projections made in 1981.

The **Chairman**. The hearing will come to order, please.

This is the first in a series of hearings on the effect that the House-passed tax reform bill will have on individuals, on businesses, on the country.

I have asked the witnesses today to testify not so much as to whether or not the bill the House passed and the administration's bill is fair.

I think that is probably a subjective judgment that each one of us have to make on behalf of our constituents and the country, and whether or not it is fair to one person and may not appear to be fair to another.

But I have asked the people that will be testifying today and for the next 2 days to give their best recommendations as to what the effect of the House bill is; to a lesser degree, what the effect of the administration bill was as it was originally introduced; and especially as it relates to capital investment, to jobs, to the growth of the gross national product, or the decline as the case may be, based upon the tax bill as best they can tell.

I hope at the end of these hearings we will have some reasonable grasp as to whether or not the bill as it passed the House helps or hurts the economy, productivity, jobs in this country.

Senator Long.

Senator **Long**. No statement, Mr. Chairman.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. I would like to welcome these distinguished economists, Mr. Chairman. I look forward to hearing them.

The **Chairman**. Senator Heinz. Senator Danforth.

Senator **Heinz**. Mr. Chairman, I would like to spend some time listening to the witnesses and asking them questions.

Senator **Danforth**. Mr. Chairman, I think you put the questions very well.

It seems to me that the test of this tax legislation is not who gets what, but rather does the bill encourage growth? Does it build toward the future of our country? Or instead, does it stimulate instantaneous consumption?

It would seem to me that, on the face of it, the House bill is one that is oriented toward stimulating consumption rather than economic growth; but I look forward to the advice of the experts.

The **Chairman**. Senator Grassley.

Senator **Grassley**. I would appreciate your reflection on the insecurity and the uncertainty of congressional debate with tax policy that has maybe inhibited some sort of economic activity in the last year and probably what will turn out to be 2 years that we will have discussed the need for tax reform, and measure that against, if you can, what sort of economic good has come from the House bill, is where we are right now.

The **Chairman**. Senator Mitchell.

Senator **Mitchell**. Thank you, Mr. Chairman.

The **Chairman**. I have asked the witnesses today, rather than confining themselves to our normal 5-minute rule, to hold themselves to 10 minutes—oh, I am sorry, George. I thought you said no statement. Go ahead.

Senator **Mitchell**. No; I do have a statement.

The **Chairman**. I apologize.

Senator **Mitchell**. I was just getting warmed up. [Laughter]

Mr. Chairman, I do have a statement. I would like to read just a portion of it, and then ask that the full statement be placed in the record.

Mr. Chairman, I commend you for these hearings. This committee has a rare, once-in-a-generation opportunity to consider fundamental tax reform legislation to reduce individual and corporate tax rates, restore fairness to the tax system, and promote economic growth.

In my judgment, and I recognize I am in a minority committee, I think the House of Representatives made a good start. The House bill is surely not a perfect document; it is not pure tax reform.

It is complex and needs some revisions, but the basic approach it takes is fundamentally sound by replacing inefficient, distorting tax subsidies with low marginal tax rates on individuals and corporations.

I think the House is to be commended for removing over 6 million low-income individuals and families from the tax rolls, while increasing the standard deduction and the personal exemption to give needed relief to working families.

These changes were accomplished while preserving the current distribution of tax burdens and maintaining the deduction for State income and local property taxes.

To taxpayers in many States, the House bill creates lower marginal tax rates than those requested by the administration.

The House bill also includes a tough new minimum tax that will ensure that all taxpayers with substantial economic income will pay their fair share of taxes.

Meanwhile, incentives for research and development and capital investment are preserved at reasonable levels that will stop the inefficient distortions of investment decisions caused by unequal tax subsidies.

I believe those are the minimum objectives that must be included in a Senate bill if we are to enact true tax reform.

There are some skeptics who believe this committee will fail in its efforts, that we will yield to those who will construct compelling reasons why it is crucial to this Nation's economic future that they continue to pay no taxes.

There has been some speculation that the committee will preserve current tax subsidies through new regressive tax burdens on individuals.

Others have suggested repealing the deduction for State and local taxes as a means of restoring tax breaks to the corporate community.

These options are unacceptable to me, and I hope after the committee has fully explored them, that the committee will reject them.

The members of the committee are understandably and justifiably concerned about the effect that tax reform will have on the ability of U.S. industry to compete internationally. That is a concern I share.

However, we should not be misled by those who will use this issue to justify their continued avoidance of taxes.

In 1981, this committee was heavily influenced by those who painted dramatic and vivid pictures of the effect that the President's then tax program would have on productive investment and savings.

The result has been exactly the opposite of what was almost universally predicted. Fixed business investment is no higher than it was in 1981, and the personal savings rate, as we all know, has continued to decline.

Over the next week, we will hear from many witnesses, and we look forward to their testimony.

We should be cautious about anyone's ability to predict the future course of the economy in the wake of structural changes in tax reform, particularly if we reflect on the inaccuracy of most of the projections made in 1981.

Nonetheless, we have to, of course, accept the best testimony we can and make the best judgments we can; and Mr. Chairman, we look forward to that.

I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator. Senator Long.

Senator LONG. Mr. Chairman, I do want to comment on something that Senator Mitchell just said.

It was recommended in 1981 that we have further incentives. There is reason to think that those incentives would have worked had we not run into the very large deficits.

Wall Street concluded that the very large deficits meant inflation for a long time and that meant high interest rates.

In turn, the perception that the interest rates would be high for a long time resulted in a very big cutback in investment, and did much to bring on the recession.

Given the type of recession, the incentives in the 1981 bill simply didn't have the power to offset the negative impression that people had toward investments.

Thus, it is not quite fair to say that that 1981 bill would not have stimulated the economy standing alone. But, it came in the midst of a very pronounced recession with high, and anticipated higher, interest rates. Given the situation one could understand why investments were not made.

In my judgment it was the economic conditions that kept the 1981 bill from doing what we hoped it would do.

The CHAIRMAN. Senator Bentsen, any opening statement?

Senator BENTSEN. I have no opening statement, Mr. Chairman.

The CHAIRMAN. All right. Gentlemen, I have asked you to hold yourself to 10 minutes rather than our usual 5-minute rule, and we will take you sequentially before we ask any questions, so that we can have all three of you together as we ask questions.

And if on occasion you disagree—and in some places, you do—we may ask you why you happen to disagree with each other, although I suppose as economists that is not a new question that you get.

We have with us today Dr. Lawrence Chimerine, the chairman and chief economist for Chase Econometrics; Dr. Roger Brinner, the chief economist and group vice president for Data Resources; and Dr. George Schink, the vice president for Research and Development of the Wharton Econometric Forecasting Associates.

Unless you gentlemen object, we will take you in the order that you are on the witness list.

Dr. Chimerine.

STATEMENT OF LAWRENCE CHIMERINE, PH.D., CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS, BALA-CYNWYD, PA

Dr. CHIMERINE. Thank you, Mr. Chairman.

I have submitted a rather lengthy statement, which I assume will go in the record.

The CHAIRMAN. All of the statements will be in the record in total.

Dr. CHIMERINE. I will restrict my remarks, as you asked, to the economic effects of tax reform, with some reference both to the administration proposal as well as the House bill.

I would like to start with the normal caveat and qualification. I think it probably goes without saying how difficult it is to measure the likely impacts of a bill this large, this complex, with so many changes.

And as a result, I am going to talk mostly about the directional impacts and restrict my remarks primarily to the impact on general economic activity, international competitiveness, and capital formation, rather than on any specific industries or specific sectors of the economy.

I think, to do that, you have got to distinguish between the effect of tax reform in the very short term and what are likely to be the longer term impacts; and I view them very, very differently.

In fact, one of my big concerns about both current proposals is that if we enact either one of them in one fell swoop, at least in the first year or so we could have a significant depressing impact on the economy because there are some extremely nasty transition effects in both programs, particularly in view of the starting conditions. I think that has to be taken into account.

As everybody here knows, the economy has been growing very sluggishly now for the last 18 months. The investment boom seems to be petering out.

The dollar is still too high to permit a major improvement in our trade deficit.

We have overbuilding all over the place, excess building.

Gramm-Rudman-Hollings—even though I think reducing budget deficits is very favorable for the long term, if we do it too quickly, it might have a depressing short term economic impact.

There has been a massive accumulation of debt and various strains on the financial system.

So, I think we all can agree right now the economy is very vulnerable to any major shock; and implementing a large tax reform proposal in the short term can produce that kind of shock.

It will come in three ways or three directions.

Both the administration proposal and the House bill will likely cause a significant decline in investment in the short term, reflecting a drop in cash flow to the corporate sector.

Both have a large corporate tax increase. Both would reduce the expected return on new investment projects.

Second, eliminating some of the incentives for building, particularly in the administration proposal, especially in view of already large-excess capacity and overbuilding, will likely cause a very sharp decline in construction for multifamily structures, for office buildings, and so forth.

This may be desirable on a long-term basis, but in the short term that will have a depressing effect on the economy.

Third, the 6-month delay in the cut in personal tax rates relative to the elimination of various deductions will also have a somewhat depressing effect on the economy.

If the administration proposal would be enacted, our estimates were that in the first year real GNP would be 1 percentage point lower than it would otherwise have been on a straight baseline case without tax reform.

The short term impacts will be less for the House proposal because they don't eliminate as many tax shelter activities in the short run; but nonetheless, also, it would likely have a modest negative effect on economic activity in the short run.

In the intermediate term, going to the next 4 or 5 years, our view is there will be a catchup. As we go through this transition process and add the benefits of lower corporate tax rates filtered through the economy, those industries that would benefit from lower corporate tax rates generally are not very capital intensive. It will take them several years to gear up; but once they do, we expect the gap will be closed.

Regardless which of the two proposals is enacted, by the time we get to the end of the decade we would expect the economy, more or less in total, to get back to nearly what it would have been on a baseline case without tax reform.

The **Chairman**. Say that again. At the end of the 5 years, we will be roughly where we are?

Dr. **Chimerine**. Where the economy would have been——

The **Chairman**. Where the economy would have been without any tax bill.

Dr. **Chimerine**. That is correct. So, a nasty short-term transition effect; a catchup within the next 4 or 5 years.

Then the key question is: What happens on a real long-term basis? And here is where I have some concerns.

There is no question in my judgment that both bills would reduce investment in the long term and stimulate consumption. There is a dramatic distribution of the tax burden away from individuals toward corporations.

The cost of capital will increase in both proposals, especially the House proposal.

And on a long-term basis, this will reduce investment in the United States, which will reduce long-term productivity growth unless we get an offset from one of three potential sources.

One of them would be: Do cuts in marginal tax rates really stimulate more saving and work effort and productivity?

The evidence of the last few years, quite frankly, as Senator Mitchell mentioned a moment ago, is very mixed at best; and you can interpret it really as being somewhat negative.

Second, there will be a shift in investment because both proposals would result in more equal tax rate across industries.

We are likely to get less new empty office buildings and more investment and more productive kinds of activities.

The second issue then becomes: Does the improvement in efficiency offset the negative effect of the reduced level of investment in the long term?

Third, if we get low interest rates or lower interest rates from tax reform, and that reduces the cost of capital, does that offset the adverse effect of lower cash-flow on long-term investment and productivity?

Senator HEINZ. Would you repeat that?

Dr. CHIMERINE. Yes. There are some who are claiming that if we implement tax reform, the incentives to borrow are reduced, primarily through lower margin tax rates and some other changes.

This would encourage more capital formation by reducing the cost of capital on a long-term basis.

In my judgment, the best that we can say, quite frankly, is we don't know whether the positive effects coming from those three sources—the effects of lower marginal tax rates, the incentive effects, the efficiency argument, and the impact of lower interest rates—all working in a positive direction would offset the adverse effect of the reduction in corporate cash-flow on the quantity of business investment.

Our best judgment is it is likely to be a wash; and if we are lucky, on a long-term basis, general economic activity in the United States would probably not be very far different than it would be without either of the two tax reform bills being enacted.

There is no evidence, in my judgment, to support the conclusion that we will get much more rapid long-term growth if tax reform is enacted than we would if we didn't.

That doesn't mean tax reform is not a good idea. I happen to support it. I think there are some other reasons for it.

But I think the evidence being offered in terms of the efficiency arguments, the incentive effects, and so forth are very, very limited at best, very unpersuasive; and we just don't see enough conclusive evidence to conclude that the economy on a long-term basis would be better off.

Now, in industrial competitiveness, here again I have a short-term concern. I still think we are having a serious problem competing effectively in world markets.

Part of the problem is the cost of capital. As you all know, the cost of capital in the United States is significantly above what it is in other countries.

This is obviously compounded by the strong dollar, by other kinds of problems with our trade situation, by import barriers overseas, foreign subsidies, and so forth.

But it doesn't seem to me to be the appropriate time to increase the cost of capital further in the United States to make our industrial competitiveness even somewhat worse.

Both the House and the administration proposals would do so.

In my judgment, as I mentioned a minute ago, I still strongly support tax reform. I think the House and the administration are going in the right direction, certainly from an equity argument.

I think both would cut tax shelter activity. They both broaden the tax base, which is desirable.

They both cut tax rates. And even though I don't think you will get major supply-side effects from that, nonetheless it is desirable because it will reduce some of the hostility toward the tax system that has now been created.

It clearly will make tax rates more equal across industries. It will limit complete tax avoidance. It might reduce the incentive to borrow a little bit; and I think we are already going too heavily into debt.

But I would suggest four or five changes from a broad perspective to both proposals that I think would reduce some of the negative impacts that I talked about a few moments ago.

First, I would combine tax reform with deficit reduction. I think reducing the deficit is the highest priority; and the way to do that, in my judgment, is to broaden the tax base and to lower tax rates by less than would be required to make the bill revenue neutral.

In fact, my concern is that both proposals currently on the table would actually lose revenues.

Second, I would reduce the degree to which the burden or the distribution of the tax system is shifted away from individuals toward corporations.

Some of that is justified. We went too far in 1981 on the investment incentives; but I think in the current environment, both bills go too far in that direction.

Third, I would strongly consider phasing the tax changes in over a long period of time to reduce the short-term transition effects, particularly the removal of the investment tax credit, which could in the short run have some very negative effects, as I said earlier, on investment.

If I might take 20 more seconds, Mr. Chairman, to respond to a point that was made earlier in terms of what the impact of potential tax reform has already been on the economy.

It is very hard to discern any overall negative effect. There are some negative effects, and there have been some positive effects.

Clearly, the vacation home business has been hurt by the potential for tax reform.

On the other hand, there has been an acceleration of other kinds of construction projects to beat the potential tax reform changes.

When we put it together, we find that over the last 6 months for the economy as a whole, the impact or the anticipatory impact of tax reform has been very, very limited, very minimal.

Thank you.

The CHAIRMAN. Dr. Chimerine, thank you. Dr. Brinner.

[The prepared written statement of Dr. Chimerine follows:]

Statement By

Lawrence Chimerine, Ph.D
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My name is Lawrence Chimerine, and I am the Chairman and Chief Economist of Chase Econometrics. I appreciate this opportunity to testify before the Senate Finance Committee on the likely economic effects of the Administration and the House tax reform proposals.

Summary

In sum, I will make the following observations:

(1) The current income tax system is characterized by numerous distortions, primarily reflecting the narrowing of the tax base during the last 25 years, and the resulting increase in marginal tax rates. In addition, it is perceived to be highly inequitable because the increased use of tax shelters and other features of the tax code have enabled many individuals and corporations to pay little or no tax.

(2) While the Administration's proposal on balance would represent an improvement over the current tax system in many respects, it would provide the largest personal income tax cut for higher income individuals -- this is difficult to justify in view of the dramatic shift in the tax burden which has already occurred in recent years. The House bill would not make the personal tax system significantly more regressive.

(3) Both the Administration and the House tax reform proposals will weaken the economy during the first year after enactment, primarily reflecting the six month delay in the effective date for personal tax cuts (in both bills), the cutback in incentives for capital spending, and the reduced tax advantages for construction. The short-term shock effect will probably be somewhat greater if the Administration's proposal is enacted.

(4) Calculating the effects of tax reform in the long term is extremely difficult. Nonetheless, our conclusion is that neither capital formation, productivity growth nor overall economic growth will be significantly higher on a long-term basis if comprehensive tax reform is enacted. This is great part reflects my view that the "supply side" effects of reductions in marginal tax rates are relatively small -- this is confirmed by the experience since the 1981 tax cuts. Labor force growth has actually slowed down since that time, the saving rate has actually

fallen, net investment is still below the levels of the 1970s, and productivity growth has lagged behind other recoveries, despite the sharp decline in marginal tax rates in 1981.

(5) The Administration's proposal would probably lead to somewhat better long-term performance than the House proposal because it includes a smaller shift of the tax burden away from individuals toward corporations, and because it would raise the expected return on new investment projects by far less than the House proposal. Thus, investment spending will be held down by less in the long term (especially during the 1990s) under the Administration plan than if the House plan were adopted. Many foreign countries already possess a significant advantage over the U.S. with respect to the cost of capital — both tax reform proposals will widen this gap even further.

(6) In my judgment, neither bill is likely to be revenue neutral, primarily because new methods of tax evasion are likely to be found in place of those loopholes that are scaled back or eliminated by the current proposals. This would be counterproductive because enormous budget deficits are already keeping interest rates extremely high and worsening our competitive position in world markets.

(7) Despite the absence of convincing evidence that tax reform will significantly increase long-term growth, it is nonetheless desirable on both efficiency and equity grounds.

(8) In my view, several changes should be made before comprehensive tax reform is enacted: (a) A further broadening of the tax base would make the system fairer and more equitable. (b) Tax reform should be combined with deficit reduction, since reductions in future budget deficits should be by far the highest legislative priority, and since any meaningful reduction in deficits cannot be accomplished without at least some tax increases. Thus, tax rates should be reduced only to a level that will permit at least some net revenue increase. (c) The dramatic shift in the distribution of the tax burden away from individuals toward corporations in both of the current proposals should be scaled back. While some movement in this direction would be acceptable, both proposals go too far in view of our already weak competitive position in world markets.

Lawrence Chimerine

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THE CURRENT TAX SYSTEM

The basic problems with our income tax system (both for individual and corporate taxes) which current tax proposals seek to address is that the combination of base erosion and increased marginal rates have made the system exceptionally complex; it has caused severe (and unanticipated) economic disincentives and distortions, and it raises relatively little amounts of revenue. In 1984, the personal income tax raised only $315 billion, less than 11 percent of personal income. The corporate income tax, excluding those taxes paid by the Federal Reserve System to the Treasury, raised only $54 billion, less than 2.5% of GNP. This relatively meager revenue raising achievement was accomplished through a tax system which contained marginal tax rates rising to 50% on the personal side and 46% on corporate income.

The corporate income tax undoubtedly has been affected the most severely by base erosion. In fact, the combination of the investment tax credit, rapid accelerated depreciation, and the sharp slowdown in inflation have caused effective tax rates on many types of capital investment to be negative. Corporate income taxes as a share of corporate economic income, and of Federal tax receipts, have fallen dramatically during the last three decades.

The decline in confidence in the income tax system has several causes. One of these is that personal income taxes have been "crowded out" by Social Security taxes. In 1960, maximum employee Social Security taxes were only $144. As these taxes rose from these insignificant amounts to their current ones, the Congress tried to tilt the tax system away from low income individuals, in an effort to maintain the progressivity of the tax system as a whole. Needless to say, this process resulted in sharply higher marginal tax rates for all middle-income individuals. The response of these individuals was both political and economic. In the political arena, middle- and upper-income taxpayers argued for increases in the number and types of exemptions and deductions which would shelter portions of their income. In the economic arena, individuals increasingly moved to take advantage of the opportunities for sheltering income. Cycles of an eroding tax base, tighter IRS restrictions, and higher tax rates resulted.

Furthermore, numerous tax expenditures have developed to address social and other objectives — these, too, have contributed to the erosion of the tax base.

In 1981 the Congress tried to reduce tax sheltering by reducing marginal tax rates, particularly those for upper-income Americans. However, the impact of this action, except in the very top brackets, was disappointing. Despite the lower tax rates and two attempts by the Congress to close loopholes in the tax code, tax sheltering activities and the public's perception of the unfairness of the tax system have increased. Tax reform, if it is to be significant, cannot be accomplished by eliminating a few relatively unpopular loopholes. Significant reductions in rates are possible only if some major popular tax expenditures and a host of minor tax expenditures are eliminated.

THE ADMINISTRATION'S PROPOSAL

The following are among the most significant elements of the Administration's tax reform proposal:

The Business Capital Income Tax Changes

In effect, the Administration has proposed a dramatic reduction in corporate tax rates by the repeal of the investment tax credit. Although this change in emphasis by the Administration from enhancing labor productivity to enhancing total factor productivity by itself is not likely to cause a major direct change in the amount of capital purchased relative to the amount of labor purchased (if the net effect would be to leave the cost of capital unchanged), these two changes to the tax system amount to a very strong statement on industrial policy. Under current law, the tax system is strongly tilted toward capital-intensive industries — if the President's proposal is adopted, most of the tilt would be eliminated. Furthermore, as discussed below, other features of the proposal would result in a relatively large increase in corporate taxes during the remainder of the decade, offsetting the net reduction in personal tax payments that would result.

The impact of the President's proposed changes to depreciation schedules needs to be examined with some care. In general, the President's new proposed Capital Cost Recovery System (CCRS) is not significantly less favorable to capital than the current Accelerated Cost Recovery system (ACRS). Indeed, under current or higher rates of inflation, CCRS is significantly more favorable to capital than the current ACRS system for most classes of investment. The major exception is structures. The impact of the switch from CCRS to ACRS on the cost of structures depends upon one's assumed discount rate. If one assumes, as the Treasury does, that investors in structures require a 4% or less real rate of return, CCRS is still more favorable to investment than ACRS. If one believes that a higher discount factor is appropriate for these risky investments, ACRS remains more attractive. A summary of the present discounted value of depreciation benefits under CCRS and ACRS (assuming a 4% real rate of return) is shown in **Table 1.**

Under virtually any reasonable inflation scenario, a shift to CCRS, in the aggregate, will not have a major impact upon the level of tax depreciation taken in the short term, so that the short-term revenue impact of the shift to CCRS would be negligible. In the long term, the inflation adjustments, coupled with longer tax lives, will result in higher rates of tax depreciation. In the intermediate term, CCRS will yield somewhat less tax depreciation. Thus, as the decade of the 1980s closes, the change from ACRS to CCRS would result in some significant revenue gains -- near the end of the century, these revenue gains would gradually disappear. Since the change in depreciation allowances has a signifciant revenue impact only during the late 1980s and early 1990s, any increases in corporate tax receipts necessary to balance personal tax reductions must come from some other source. (To some extent this need is lessened by the typical assumption that, if left unchecked, some of the closed personal tax loopholes, particularly in pension and income shifting areas, would grow rapidly during the 1990s.)

The long-term increases in corporate tax receipts come largely from three or four base broadening changes. These changes do not affect the structure of the tax system, but strike heavily at specific practices in place in particular industries. Therefore, they can be expected to have strong industry-specific effects. For example, significant changes are made to the provisions of tax codes which allow fairly rapid expensing of costs incurred in the production of multi-year income. Those industries, such as defense-related industries and construction companies, which historically have been able to deduct expenses ahead of income, will face significant increases in taxes. Financial institutions will also be faced with significant tax increases due to some provisions such as a stricter limitation on excess bad debt deductions. Multinational companies will face tighter restrictions on their accounting systems which will have the effect of raising their U.S. tax liability.

Although these base broadening items will probably meet the Administration's long-run revenue balancing needs, they do not provide sufficient funds in the middle and late 1980s to make the proposal revenue neutral. The Administration has therefore proposed to tax corporations based upon past ACRS deductions. The argument is that corporations which received large "front-loaded" benefits from ACRS would receive a windfall to the extent that their deductions were taken under old marginal corporate tax rates, and much of the revenue that will accrue from the investment would be received under the new, lower marginal tax rates. Thus, the Treasury proposed a tax which would "recapture" some of the tax benefits provided by ACRS. Since this tax would be on old rather than new investment, presumably it would have minimum incentive effects, although corporate cash flow would certainly be reduced. In effect, companies which received large ACRS benefits would have their tax cut partially or entirely delayed for several years.

The net effect of the changes would be to raise the cost of capital on most new investment somewhat, and, importantly, reduce the corporate cash flow available to finance investment during the next several years.

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The Distributional Impacts — Personal Income Taxes

The largest individual distributional impacts of the President's tax reform proposals will be between itemizers and nonitemizers. Those persons who have structured their economic affairs so as to take maximum advantage of the current tax code will receive small tax reductions, and in many cases substantial tax increases. Since the largest "loophole" to be closed is state and local taxes paid, it is clear that the differential regional impacts will be immense. In particular, most taxpayers in high tax areas will suffer both higher Federal income taxes and reduced property values. The economies of the regions will also suffer on a relative basis. Interestingly, some taxpayers in high tax regions may even face significant increases in their marginal tax rates.

The size of the marginal tax rate cuts differs significantly by income segment (see **Table 2**). In particular, people taxed at a 15% marginal rate were previously taxed at rates ranging from 11% to 18%. Similarly, many persons in the new 25% marginal rate bracket were taxed at rates ranging from 23% to 26%. Persons who will be in a 35% tax rate bracket were taxed at rates ranging from 38% to 42%. Since state and local income, property and sales taxes will no longer be deductible, and, for some of these persons taxes are roughly proportional to income, some of these individuals will find that their marginal as well as their average tax rates have actually increased!

The Adminsitration proposal would of course produce a decline in personal tax payments -- much has been said about the impact of the tax proposal on income distribution. The standard analysis, depicted in **Figure 1**, shows that the tax cuts are about proportional overall. Substantially large tax cuts, as a percent of total taxes, were made at the lowest income level; somewhat higher than average percentage tax cuts were made at the upper-income level, and slightly smaller than average tax cuts were made for middle-income taxpayers.

However, a better way of looking at the distributional aspect of the tax cuts is to compare the cuts to income. This comparison is shown in **Figure 2**. As is indicated, the tax cuts are roughly proportional to income for a wide range of taxpayers. In particular, virtually all income classes of taxpayers who pay significant income taxes will receive tax cuts equal to between 0.5% and 0.7% of economic income. The only major exception is upper-income taxpayers, who will receive tax cuts equal to almost 2.5% of their economic income. This appears to be highly unacceptable in view of the dramatic shift in the tax burden (away from higher income groups toward the middle- and lower-income groups) which has already occurred in recent years.

One other significant distributional impact concerns two-income families since the proposal discourages two-worker households in several ways. The second largest tax "loophole" to be closed is the second-earner deduction. In addition, nonworking spouses are allowed to establish IRAs, a provision which not only calls the entire concept of an IRA as a pension into question, but also increases the implicit after-tax cost of a working spouse. Other provisions, such as the nondeductibility of state and local income taxes, the changing of the child care credit to a deduction, and the moving of miscellaneous business expenses "above the line" also will make it less attractive economically for second earners in a household to work.

Industry Distribution Impacts

The distributional issues affecting corporations are at least as important as those which affect individuals. The Treasury argument that it is not skewing the tax system against specific industries but merely removing current subsidies is largely correct. The industry distribution impacts occur for several major reasons. First, the current bias in the tax code against investment by unprofitable firms is removed. Second, accounting practices commonly utilized in several industries are specifically targeted for repeal. The most important of these changes are in multiperiod expense and income matching, energy subsidies, and tax benefits utilized by finanical institutions. The third distributional issue affects profitable companies in industries which require large amounts of capital investment. Large capital users will be hit hard by the repeal of the investment tax credit. Only a very small portion of this loss could be offset by the slightly more generous depreciation provisions. Also, companies in these industries, to the extent that they took advantage of ACRS depreciation during the past four years, will not receive their tax cut in 1986; rather, they will have all or a portion of it deferred until 1989. The final group of companies which will be impacted by this proposal are those which are heavily dependent upon those parts of the economy which are likely to be adversely affected by the proposal. Sellers of equipment and builders of (and suppliers to) multifamily housing construction and commercial construction will undoubtedly be hurt disproportionately (to be discussed further later).

Needless to say, companies which are not capital intensive, either because they are labor intensive (and most expenditures are automatically expensible) or are research and development intensive (and can benefit from both the immediate write-off of R&D expenditures and the research and experimentation tax credit) will prove to be large winners should this tax system be adopted. Producers of high-technology equipment will suffer somewhat from the loss of the investment tax credit, but, because investments in these types of equipment typically show rates of return substantially in excess of a company's hurdle rate even without the tax credit, and because the lower corporate tax rate enhances the profitability of all types of investment activity, the impact will be cushioned.

THE HOUSE TAX REFORM PROPOSAL

The House tax reform proposal which, while it has some important differences with the Administration proposal, follows the same broad outline. Thus, it is: **(a)** allegedly revenue neutral, **(b)** would produce a sizable shift in the tax burden away from individuals toward corportions, **(c)** does broaden the tax base, **(d)**enacts a stiffer minimum tax, **(e)** cuts marginal tax rates somewhat for both individuals and corporations, and **(f)** most provisions would take effect in 1986. There are some major differences, however, most notably that, under the House proposal, the deduction for state and local taxes would be maintained. The revenue loss from maintaining this deduction would be offset by lowering the income levels at which higher marginal tax rates kick in for individuals, and shifting somewhat more of the tax burden away from individuals toward corporations. Accelerated depreciation would be cut back dramatically, but there would be no "depreciation recapture" provision.

Some of the major features are listed below:

Individual Taxes

Few individual tax loopholes, exemptions, credits or other expenditures were closed. The House did vote to eliminate income averaging, the political contributions credit, the dividend received credit, and the marriage penalty deduction. Most other tax expenditures were scaled back, but not killed. For example, tax shelter regulations, particularly those relating to real estate, were tightened somewhat. The capital gains exclusion was reduced from 60% to 42%. A 1% gross income set aside was put on miscellaneous business deductions. Regulations concerning trusts, estates, and unearned income received by dependent children were tightened. The value of 401(K) plans was sharply reduced, both by integrating the contributions with IRAs and by restricting the maximum contributions.

In addition, the House adopoted sweeping provisions designed to make tax loopholes less valuable. First, the standard deduction was raised, both directly and by reducing the value of itemized deductions by an amount equal to $500 per personal exemption taken. A family of four thus will receive no benefits from itemzing until (and unless) their deductions exceed $6,800. Second, a minimum tax was proposed which is equal to 25% of the sum of all income plus all "preferences." (The first $40,000 of income -- $30,000 for single taxpayers -- is exempt.) Several new items were defined as preferences, including appreciated gifts of property, certain investment losses in excess of investment, and interest on newly issued tax exempt bonds.

Thus, the bill is, to a large extent, a "down payment" on tax reform. It is not tax reform in the same sense as the earlier proposals, since few loopholes are actually eliminated. However, the bill does significantly reduce horizontal inequities. Furthermore, by making preferences far less valueable, the constituency for these preferences is reduced. If the proposal passes, both the number of Americans using preferences and the value they receive from them will be sharply reduced. With their political constituency weakened, a "new" reform proposal appearing some years hence might well eliminate many of these preferences entirely.

Since very few preferences were entirely eliminated and a large amount of income was automatically exempted from taxation due to the higher standard deduction and personal exemption, there was not much room left over for marginal rate reduction (other than that achieved by shifting about $140 billion in taxation from individuals to corporations over the next five years). As a result, the **marginal** tax rate reductions are far less impressive than those proposed by the president. (Since reform is, in theory, a zero sum game and the shift in burden to corporations is only slightly higher than in the President's proposal, the **average** rate reduction remains about the same.) As is shown in **Table 3**, the House bill substantially lowered the "break points" at which the higher brackets are effective. The 25% rate is applied to incomes between $22,500 and $43,000 (joint returns) -- by contrast, the President's proposal would have applied the 25% rate to incomes between $29,000 and $70,000. As is further shown in Table 3, the marginal tax rate reductions are virtually eliminated for joint return taxpayers who do not either have incomes of: (a) about $20,000, (b) about $40,000 or (c) over $65,000. Single and head of household taxpayers face similar situations, albeit at differing income levels. Oddly enough, the Committee received a good deal of criticism for adding a fourth tax bracket. However, many individuals in this fourth bracket actually face only modestly higher marginal rates than under the President's proposal because state and local taxes remain deductible.

Corporate Taxes

Although personal tax reform is often stressed, the House bill is primarily a corporate tax reform vehicle. Indeed, tax reform has become synonomous with shifting the burden from individuals to corporations, by effectively reversing the capital formation incentive provisions of 10-5-3 depreciation. In the House bill, this is accomplished by eliminating the investment tax credit, and by reverting back to a depreciation system based on economic lives. As had been true in the past, economic lives would be estimated through the ADR (Asset Depreciation Range) system (see **Table 4**). For equipment producers and purchasers, some of the pain would be eliminated through the use of 200% declining balance depreciaton. Most structures, however, will be allowed only straight line depreciation with 30-year tax lives.

Organizations which were perceived as receiving extraordinary benefits under current law were also the subject of special provisions designed to create greater "horizontal equity." Banks, thrifts, insurance companies, defense contractors, large construction firms, multinationals, oil and gas producers, and minerals and timber producers would all be hit with special tax increasing provisions. The R&D tax credit was reduced, as were many ESOP benefits. Also, 20% of business entertainment expenses were made nondeductible.

As was the case with individuals, the House was determined to eliminate the spector of well-off entities paying no tax -- as a result, a much tighter 25% minimum tax was imposed on corporations. One major aspect of the House bill is that it would raise the rental cost of capital on new investment during the rest of this decade by far more than the Administration's proposal (upward of 20%) because of the scaling back of depreciation allowances on top of the elimination of the investment tax credit, even though the total increase in corporate taxes would be only slightly higher.

Purists will certainly be able to argue that the House bill does not represent "real" tax reform. Indeed, the tax code under the House proposal will be significantly more complex than under current law. Also, marginal tax rates were not reduced very much for a large block of taxpayers. Indeed, the National Taxpayer's Union estimates that almost 40% of all taxpayers would face no decline in marginal tax rates at all as a result of reform.

However, the bill does achieve some of the original objectives of tax reform. The top marginal tax rates for both individuals and corporations are reduced sharply. Under the proposed House system, it would be far more difficult to evade taxes entirely. Tax payments by entities (both individuals and corporations) in similar financial circumstances will be far more equal. Taxes of low income Americans would be reduced (and in many cases eliminated) and the need to itemize deductions would be eliminated for most Americans with moderate or low incomes. Furthermore, these goals would be accomplished with short-term shock effects -- on property values, on high local tax regions, or on construction activity -- which would probably be considerably less than under the Administration proposal (see below).

ASSESSING THE ECONOMIC IMPACT OF TAX REFORM

Macroeconomic models are somewhat limited in analyzing the economic impacts of tax reform proposals as far reaching, as comprehensive, and as structural in nature as those under consideration. Many of the changes are microeconomic in nature and cannot be captured precisely in econometric models. In addition, many of the changes which have been proposed are so distinct from current law that they do not fit comfortably into the structure of macroeconomic models. For example, no current macroeconomic model is designed to calculate the change in the rental cost of capital should indexing be adopted. Also, some of the changes which are proposed are well outside the range of estimation of most econometric models. Finally, some of the most dramatic impacts will probably result from aspects of the law which are very poorly understood or are difficult to measure.

Nevertheless, a macroeconomic simulation can be a useful tool for determining the directional changes and the rough orders of magnitude one would expect from proposals of the type currently under consideration. Furthermore, secondary impacts, such as the Keynesian feedback effect from reduced investment expenditures, or the increase in consumption due to increased dividend payments, can be estimated fairly reliably. Finally, models are extremely useful in calculating the industry and sectoral impacts of macreconomic changes. Although these calculations are, of necessity, crude, they do pinpoint the areas which are likely to face extreme reductions (or increases) in final demand.

The most important changes entered into the Chase Econometrics Macroeconomic Model stem from the dramatic changes in the incentives to invest in both tax reform proposals. The areas most strongly affected are those which are, to a significant extent, financed through tax shelter partnerships, such as multifamily rental home construction and some types of commercial construction. Those types of equipment which are strongly favored through the combination of the investment tax credit and rapid depreciation write-offs will also experience a large direct impact. Other important changes entered into the model include the shift in after-tax income toward individuals (and hence consumption) from business (and hence investment) as a result of the shift in the tax burden.

Another important impact is a presumed reduction in interest rates. The Administration has argued that interest rates will be reduced directly via the reduction in the tax benefits for borrowing. However, the magnitude of this effect is probably quite small. Also, for many types of borrowing (e.g., borrowing by the Federal Government) the elasticity of demand for funds is relatively insensitive to interest rates -- even private credit demands have accelerated dramatically in recent years despite extremely high real interest rates. And, the elasticity of the supply of saving to interest rates appears to be relatively low. However, interest rates would fall somewhat should tax reform be adopted since the Fed would presumably quickly move to partly offset any decline in the desired level of investment caused by a reduction in investment incentives by easing monetary controls. Since the sectors of the economy which are most directly affected by easier monetary policy match -- to a larger extent than is usually possible -- those which would be adversely affected by the change in incentives, this type of policy change makes even more sense.

ECONOMIC EFFECTS OF TAX REFORM

In analyzing tax reform, it is extremely important to differentiate between the likely short-term effects and the long-term impact. This is important for several reasons. First, it is much easier to measure the likely effects on demand in the short term than the incentive and efficiency impacts that take many years to build. Second, any proposal that would cause serious short-term economic weakness may create sizable damage to the economy which may not be offset for many years. Third, as a result of relatively slow growth during the last year and a half, of current strains in the financial system, of the possible short-term restrictive effects of deficit reduction, and of the age of the current expansion, the U.S. economy is particularly vulnerable to any other policy changes that would cause negative short-term shocks.

Table 5 shows the current Chase Econometrics forecast for selected key variables for 1986, as well as for the rest of the decade. The relatively slow growth environment expected for 1986 can be seen from the figures shown in Table 5. In addition, we expect relatively modest growth to continue for the rest of the decade although it is likely to be somewhat stronger than during 1986. While recent declines in interest rates and the dollar will begin to stimulate economic growth in 1987 and beyond, this is likely to be offset by assumed budget cuts and tax increases during this period. In effect, we are assuming that approximately half of the changes required to achieve the current Gramm-Rudman deficit targets will be implemented -- if spending cuts or tax increases are larger than we are assuming, this would cause even somewhat slower growth during much of the rest of the decade, even with the relatively accommodative monetary policy, the modest additional declines in the value of the dollar on foreign exchange markets, and the continued weak oil prices that we are assuming. This reflects the fact that fiscal policy changes affect the economy much more quickly than changes in interest rates and exchange rates so that deficit reductions would have a somewhat net restrictive impact on the economy for at least two years starting in 1987. Thus, any comprehensive tax reform proposal that will be enacted is likely to take place in an environment of already very modest overall growth, and growth in investment, during the next several years.

Short-Term Effects

Any assessment of the likely short-term impact of comprehensive tax reform will thus depend on the starting conditions and on other key assumptions. In my judgment, the current economy is extremely vulnerable to any negative shock because of its less than healthy condition. The economy has been far weaker than many have claimed in recent years, despite the strong recovery. In part, this results from the fact that the recovery was rapid only for a very limited period, namely during 1983 and the first half of 1984. Furthermore, the misinterpretation of economic performance has in part resulted from a failure to distinguish between the **direction** and the **level** of economic activity -- while the recovery in 1983 and the first-half of 1984 was strong in terms of magnitude of increase, the **level** of economic activity was still considerably below its potential. This reflects the extremely weak conditions from which the recovery began because of the severity of the 1981-82 recession, and the fact that it followed so closely on the heels of the previous one. In fact, unemployment, capacity utilization, profits, and other important measures of economic performance were still far from satisfactory in mid-1984, and in most cases, had not even returned to the relatively sluggish levels which existed in the late 1970s. Several industries and geographic areas were particularly depressed (and still are), having experienced virtually no recovery at all, indicating both a high degree of imbalance in addition to the far from healthy overall picture.

Furthermore, growth has slowed sharply since mid-1984, to about a 2.5% annual rate, despite the fact that the recovery was far from complete, and despite still enormous budget deficits. In my view, these growing deficits have been a major factor causing interest rates to remain well above historical levels, and, because high interest rates have led to an increase in net foreign demand for U.S. assets, they have also been a principal cause of the overvaluation of the U.S. dollar in recent years. Interest rates have been especially high when measured relative to the inflation rate for goods (which has held back capital spending and inventory accumulation) and relative to wage growth (which has reduced the demand for housing). The overly strong dollar exchange rate has also restrained economic activity in the United States in two ways: **(a)** It has been the major factor behind the very sharp and widespread increases in import penetration, and relatively weak exports, which have produced enormous U.S. trade deficits. **(b)** The strong dollar has caused a profit squeeze in many industries by preventing many companies from raising prices; this in turn has reduced the growth in capital spending below what would otherwise have occurred.

Interest rates and the U.S. dollar have thus been too high to permit more rapid economic growth and are therefore the two principal factors preventing a faster completion of the recovery process -- in turn, both are primarily caused by high and rising Federal budget deficits at a point in the recovery when such deficits should be falling sharply. Federal deficits, and the tax cuts that have largely caused them, have thus became counterproductive for economic growth -- their direct stimulus is being outweighed by the adverse effects of the excessively high interest and dollar exchange rates which they caused.

Although some recent statistics have shown improvement, the data on balance indicate that the underlying economic picture is essentially unchanged -- the economy appears to be neither accelerating nor falling into recession, but is continuing to grow at only a relatively slow rate.

Even without any major policy changes, a continuation of relatively slow and erratic growth during 1986 is likely, for the following reasons:

(1) The outlook for consumer spending is not highly favorable. The growth in household income has slowed dramatically, primarily because of a sharp deceleration in the growth of average wages. This in turn is due to both wage cutbacks and a shift in the employee mix away from high-wage earners toward lower wage occupations and industries. The latter trend primarily reflects rising import penetration, which has caused a loss of jobs among both relatively high-paid production and nonproduction workers in numerous manufacturing industries. Furthermore, the growth in consumer spending last year, while less buoyant than earlier in the recovery, has nonetheless far outstripped income gains. Eventually, the slowdown in income growth will cause even weaker growth in spending, especially since debt levels are more burdensome than earlier in the recovery. Spending is not likely to collapse, however, because some of the recent decline in the saving rate is due to weak farm and interest income, most of which reduces savings in the short term, and because the increases in the stock and bond markets have bolstered household net worth.

(2) Construction spending is also likely to slow, despite lower interest rates, because of significant overbuilding in recent years. In fact, already extremely high vacancy rates for office buildings will worsen in many areas during the next 12 months as projects now underway reach completion. Vacany rates are also high for apartments and condominiums in many regions. This, too, will be aggravated by relatively high completions in the months ahead, reflecting a surge in new starts in recent months caused by fears that tax-exempt revenue bond financing will be curtailed. Industrial construction is already weakening, as increased outsourcing and shifting of production overseas aggravate already low operating rates in many industries. And, while commercial construction remains relatively strong, retail activity is not keeping pace -- this is likely to slow the rate of increase in construction of new stores and shopping centers. Finally, while single-family housing construction will benefit from lower mortgage rates, the impact will be modest, reflecting: **(a)** a continuing shift away from adjustable rate mortgages, which has limited the decline in effective mortgage rates; **(b)** tighter mortgage standards (higher downpayments and/or higher income coverage) in effect throughout much of the United States, which offsets some of the benefits of lower interest rates; **(c)** a substantial reduction in available pentup demand for new homes, especially among younger buyers; and **(d)** slower income and job growth.

(3) Recent declines in the dollar are still not sufficient to materially affect the near-term trade outlook in view of the only small impact on relative prices, and the long lags before exports and imports respond to price changes. Thus, while the trade deficit is not likely to rise as rapidly as in recent years, it is not likely to improve sufficiently to have a major impact on the economy until late 1986 at the earliest.

(4) Despite sharp inventory cutbacks in some industries so far this year, and relatively low inventory/sales ratios, any inventory rebuilding during the next year will be very modest. This reflects still high interest rates in relation to the inflation rate for most commodities and finished goods, and an extremely cautious attitude by most businesses because of the profits squeeze. Most companies are also expecting only modest increases in sales at best, and are gearing their inventory policies accordingly.

(5) It is becoming increasingly apparent that the capital spending boom has petered-out. Orders for capital goods have been relatively weak for more than a year. Still high real interest rates, low utilization rates, and still soft profits also suggest that capital spending will not lead the economy forward during the period ahead. If anything, recent survey and appropriation data indicate that spending plans are being scaled back, especially by hard hit manufacturing companies. In fact, were it not for efforts to modernize and improve productivity in many industries, a sharp decline in capital spending would likely occur.

Table 6 compares the likely impact of tax reform relative to the base case for each of the next five years for selected key economic indicators -- the likely effects of both the Administration and the House proposal are shown. The underlying assumptions for both of these simulations are identical to that used in calculating the base case, except for the assumption of a slightly more accommodative Federal Reserve policy. As indicated earlier, alternative assumptions would obviously produce both a different standard forecast, and different projections for the tax reform cases; however, the increments of the tax reform cases relative to the base case would be only marginally different. Both tax reform simulations were calculated assuming a 1/1/86 effective date (no allowance is made for the fact that the year has already begun), and assuming revenue neutrality. If the effective date were to shift to perhaps 1/1/87, the incremental effects would vary somewhat from those shown in Table 6 for 1986 (and so on for later years) because of the change in the initial conditions, but the differences are not likely to be large.

As can be seen in Table 6, it is very likely that immediate enactment of the President's complete proposal would have significant adverse effects on economic growth in the very short term. In particular, the elimination of the investment tax credit, reduced depreciation, and the windfall depreciation recapture would combine to significantly reduce the expected after-tax return on investment projects for many companies. On a net basis, these changes add up to a sizable increase in corporate taxes in the short term, even with the lower corporate tax rates provided for in the proposal. Given the already stagnant investment climate that has developed as a result of high interest rates, sluggish economic growth, and low and falling capacity utilization, investment would likely weaken further, especially since it would take years for many of the companies that will benefit from lower corporate tax rates to gear up their investment programs. Furthermore, without the current tax breaks, many of the construction projects that are now being considered, especially for office buildings, shopping centers, and apartment buildings, could not be justified. Vacancy rates are already extremely high for these types of strucutres, with relatively soft demand and declining rents in many areas. And it matters little for near-term economic activity and employment whether the construction projects and capital spending that are abandoned are "good projects" (that is, would have an acceptable return even without some of the current tax benefits), or are bad ones. Weakness in the economy in the short term could also result from the fact that the Administration's proposal would eliminate many personal deductions on January 1, 1986 but would not lower personal tax rates until July -- many families would thus experience a tax increase for six months. (This also causes secondary effects on investment.)

The simulations indicate that the House tax proposal will have less of a short-term shock effect than the Administration's proposal, although it would cause slower growth in 1986. The adverse impacts on housing construction, tax shelters, and business construction would be reduced by the House bill, although construction of all types will be depressed, and equipment purchases will slow somewhat. Furthermore, as in the Administration case, a pickup in consumption will be delayed by the uneven timing of the proposal which results in actual tax increases in the first half of 1986.

In sum, the major economic effects during the first year of enactment of the two proposals are likely to be as follows:

(1) Investment in business equipment will drop sharply from what would otherwise occur, with the decline being somewhat greater if the Administration's proposal were enacted. These declines in business investment will come primarily from reduced business cash flow, as well as from the indirect effects of slower overall economic growth.

(2) Investment in business structures will drop even more sharply under both cases. Under the Administration plan, commercial and office building construction will be particularly hard hit because of various provisions which would sharply curtail tax sheltering through syndication. Under the House bill, the increase in the rental cost of capital for industrial structures would result in a sharper decline in construction of such structures -- commercial and office building construction will not fall as dramatically as under the Administration's proposal because tax sheltering will not be curtailed as much.

(3) Multifamily housing construction will drop sharply (up to one-third) under the Administration's proposal because of the virtual elimination of tax syndications as well as a sharp cutback in tax exempt industrial revenue bond financing. Multifamily construction would also decline if the House proposal were enacted, but by a smaller amount.

(4) Single-family housing construction will be impacted by a number of factors if tax reform were enacted. Under the Administration's proposal, the elimination of property tax

deductions and lower marginal tax rates (which reduce the value of the tax deduction for mortgage interest) as well as the likely curtailment of vacation home construction would work in the negative direction -- this will partly be offset by somewhat lower interest rates and by somewhat faster growth in after-tax income due to personal tax cuts. Furthermore, the value of housing related deductions is very low for most home buyers, especially for younger buyers, because of their relatively low marginal tax rate. Thus, on a net basis, we expect only a small decline in single-family housing starts in the short run under the Administration's proposal. Under the House proposal, vacation home construction will be virtually unaffected and property tax deductions will remain intact. Furthermore, marginal tax rates for any individual will be higher than under the Administration's proposal. Thus, on balance, we expect virtually no decline in single-family housing construction under the House proposal during the first year.

(5) After tax profits will drop sharply under both proposals, with a somewhat larger decline under the Administration's proposal. This reflects the fact that the economy will be somewhat weaker and that profits calculated on a tax basis would not be bolstered by lower depreciation as would be the case under the House proposal. This is partly offset by the fact that corporate tax rates would be higher if the House proposal were enacted.

(6) The personal tax cuts under both proposals will bolster disposable income in the short run -- under the Administration's proposal, however, this would be almost completely offset by reduced income associated with weaker economic activity.

(7) The net effect of these changes will be to reduce GNP by about 1% in the first year if the Administration's proposal were enacted, with a much smaller, but still negative effect, if the House proposal were implemented.

It should be noted that larger budget cuts and/or tax increases designed to actually meet the Gramm-Rudman deficit targets in the near term, coupled with the depressing effect of tax reform, would produce an even weaker environment than is shown in Table 6 for all three cases.

The likely adverse short-term effect on investment of both tax reform proposals could turn our to be even be larger than currently expected, in part because faster deficit reduction (if it occurred) would weaken the economy more sharply, and in part because of the enormous accumulation of debt by the corporate sector in recent years. Much of this debt has resulted from a substitution of debt for equity resulting from leveraged buyouts, corporate stock buybacks, mergers and acquisitions. The reduction in cash flow which will result from large corporate tax increases during the next several years if tax reform is enacted will make this debt increasingly difficult to service, possibly resulting in sharper declines in business investment.

Long-Term Effects

As discusssed earlier, it is far more difficult to assess tax reform's likely impact on economic growth in the longer term. But one thing can be said with a high degree of confidence -- that excluding any indirect or feedback effect, both the Administration and the House tax reform proposals would lead to less investment and more consumption on a long-term basis, reflecting the shift in the tax burden toward higher corporate taxes and lower personal taxes. This would be more severe under the House proposal because of the large increase in the cost of capital for new investment that would result and, of course, would almost certainly mean a lower capital stock, and lower capital/labor ratios -- on a long-term basis, this would likely cause lower productivity and thus slower economic growth. Thus, for tax reform to produce significantly stronger long-term growth (as the Council of Economic Advisors predicts) other factors would not only have to offset this negative effect, but would have to cause additional economic growth on top of that. Such a change would have to come from one of three sources:

Greater Incentives: Many argue that further reductions in marginal tax rates would have a highly stimulative effect on work effort and saving, by increasing the after-tax return of both. However, it is easy to make the argument in the other direction. A higher after-tax return on saving may actually cause people to save less because they can generate the same total saving pool with a lower saving rate. The United States does not appear to be a saving-oriented society, so that changes in after-tax rates of return do not have significant effects on saving patterns in either direction. The same is possible for labor supply; an increase in after-tax wages would mean that many workers can generate the same income by working less. In fact, performance since the substantial reduction in tax rates in 1981 (as well as the highest real interest rates in our history) is not encouraging:

(1) The growth in the labor force has slowed markedly since 1980, in part reflecting a sharp slowdown in the rate of increase in the participation rate. This has occurred despite the reduction in marginal tax rates in recent years, which was supposed to have stimulated more work effort.

(2) Despite sharp cuts in marginal tax rates, the enactment of IRAs, Keoughs, and other direct savings incentives, extremely high nominal and real interest rates, and declining inflationary expecations, the personal saving rate during the last four years has averaged considerably less than in earlier years. Thus, even after adjusting for other factors, it does not appear as if there has been any permanent increase in savings as a result of policy changes in recent years.

(3) The rate of increase in productivity has been below the rate of increase during the first three years of most previous recoveries. While productivity growth is exceeding its growth during much of the 1970s, the relatively modest rate of increase during the recovery thus far is somewhat disappointing in view of the emphasis on productivity enhancement and cost cutting. Most significantly, productivity growth has slowed sharply during the last year, also suggesting that, at least at this point, the improvement in the underlying trend growth in productivity has been very modest at best.

(4) Despite the so called "investment boom," real net investment as a share of GNP has only recently returned to the levels which existed in earlier periods. Investment was extremely depressed in the early 1980s, so that the sharp increase in investment spending in 1983 and 1984 simply returned us to previous levels. In addition, a relatively large fraction of current investment is for short-lived assets, many of which do not add significantly to capacity.

Thus, it seems inappropriate at this point to count on "incentives" as being a major source of significantly higher real growth by causing more saving-induced capital formation and/or an increase in the supply of labor.

Efficiency: The second possible factor is efficiency -- the Administration argues that its proposal would result in investment decisions being made primarily for economic considerations, rather than tax considerations, so that the mix of investment in the future will be geared more toward projects which can be justified on a pre-tax return basis. Thus, instead of building more empty office buildings because they are attractive tax shelters, we will be spending more for machinery and equipment that can improve productivity growth. However, while there clearly is some merit to this argument, it does not seem likely that sufficient additional productivity growth could occur in order to produce the extra GNP assumed by the Council of Economic Advisors. Even if the reduction in the **level** of investment caused by the shift in the tax burden was all in projects that contributed nothing to productivity (which is unlikely), productivity would not be changed. Thus, the mix of remaining investment spending would have to be changed signficantly toward projects which are more oriented toward increasing productivity; this presumably would result from a shift in investment across industries in response to more equal tax rates. The Administration's optimistic assessment of tax reform is based on the assumption that average annual productivity growth over the next ten years will rise by 0.2% to 0.3%, or 10% to 15% more than what is now expected. While the shifts in investment may be very favorable at the margin, it is virtually impossible for them to have effects of that magnitude on **average** productivity, particularly since productivity growth depends heavily on many other factors (including the quantity of investment spending, which would be lower under both tax reform proposals), and because it will take many years to replace a signficiant amount of the existing capital stock with more productive capital goods.

Thus, improvements in productivity due to efficiency gains are likely to be relatively small. These will be even smaller if the House plan is adopted, especially after the next several years.

Interest Rates: A third way in which tax reform could stimulate long-term growth is if it produces lower interest rates, aside from those that would be caused by weaker economic conditions. Thus, if reductions in marginal tax rates and other changes embodied in either of the tax reform proposals reduce the incentive for borrowing below which would otherwise occur (and thus exert downward pressure on interest rates), it is possible that both investment spending and economic growth would be higher than would otherwise be the case. However, despite sharp increases in real interest rates in recent years, total borrowing has accelerated dramatically, indicating very little or no sensitivity of the demand for borrowed funds to interest rates. Furthermore, both households and corporations are now already heavily in debt so that it is unlikely that any declines in rates will stimulate further increases in the demand for credit. Thus, only marginal effects on investment, productivity, and economic growth would be likely from this factor.

The likely effects of the two tax reform proposals in the immediate term (1986-1989), as shown in Table 6, would be as follows:

(1) Investment spending for equipment would remain significantly below the levels which would otherwise occur, although the gap relative to the base case would narrow somewhat from the first year difference.

(2) Investment in business structures will remain very depressed throughout the period, particularly if the Administration's program were passed.

(3) Multifamily housing starts would remain below the base case under either program, with the gap somewhat larger under the Administration's proposal.

(4) Single-family housing construction would be slightly lower in the base case under either program.

(5) Under the Administration's proposals, after-tax profits will remain significantly below what would otherwise occur, primarily reflecting the depreciaton recapture provision. After-tax profits reported on an IRS or tax basis will actually be higher than the base case under the House proposal because of less generous depreciation (but cash flow would be lower).

(6) Overall economic growth would remain below the base case under both scenarios, although the gap would gradually narrow during the period.

(7) Primarily because of faster growth in after-tax income, the saving rate would be marginally higher under both tax reform proposals.

While not shown in the tables, it is likely that the patterns would change considerably beyond 1990. In particular, we would expect that the level and growth rate of the overall economy would not change significantly if the Administration's tax reform proposal were enacted than would otherwise be the case. The economy would be characterized by less investment but more consumption, but primarily because the improved efficiency of investment would roughly counterbalance the decline in the volume of investment, overall productivity growth would remain relatively close to a no tax reform environment. However, we would expect that capital formation, productivity growth and overall economic growth would lag behind what would otherwise occur if the House proposal is passed. This primarily reflects the fact that the Administration's proposal will be very generous with respect to depreciation during the 1990s, in part because of more favorable indexing. This suggests that the level of investment will be higher under the Administration's proposal than under the House proposal. Furthermore, some of the decpreciation windfall tax will no longer be in effect under the Administration's proposal. Thus, we believe that the House proposal will be counterproductive for economic growth during the 1990s and beyond.

On balance, therefore, the following can be said about the long-term effects of tax reform. First, the level of investment spending will be lower if either tax reform proposal were enacted than would otherwise be the case because of the shift in the tax burden. Second, recent experience suggests that neither the incentive effects nor the impact of potentially lower interest rates would fully offset the adverse effects of higher corporate taxes on the level of investment. Third, there would very likely be an improvement in efficiency -- that is, a shifting of investment into projects that can be more easily justified on a pretax return basis. This should lead to some net improvement in overall productivity growth. When we add the plusses and minuses, our general conclusion is that overall economic conditions will not be significantly changed on a long-term basis if either tax reform proposal were enacted. Capital formation, productivity growth and economic growth in the long-term would be somewhat higher under the Administration's proposal because it includes a somewhat smaller tax shift toward corporations, and because it will cause less upward pressure on the cost of capital, and thus it would not retard capital formation as much as the House proposal (during the 1990s and beyond). On the other hand, as discussed earlier, it is also likely that the Administration's proposal would result in larger transition effects, which would produce a somewhat weaker environment shortly after enactment.

REVENUE NEUTRALITY

Both the Administration and the House Ways and Means proposals are alleged to be revenue neutral. However, while such neutrality could very well occur on a static basis, it is likely that both programs would result in revenue losses, because the expected revenue gains from the scaling back of various exemptions, closing of various loopholes, etc. would be less than currently expected because new loopholes would be found to substitute for them. Also, lower marginal tax rates will probably not reduce tax cheating as much as expected. This was not assumed in the simulations, however.

In my judgment, such an outcome would be highly counterproductive because upward pressure on interest rates and/or the U.S. dollar on foreign exchange markets would result, causing slower economic growth in the years ahead.

CAPITAL FORMATION AND INDUSTRIAL COMPETITIVENESS

The reduction in the preferences for investment may be too sharp. Presently the tax code subsidizes some forms of investment dramatically, including the rehabilitation of houses which should be torn down, the building of multifamily homes and commercial office building without any hope of filling them with occupants, the buying of unneeded equipment, particularly at year-end, because of large tax subsidies. Surely there are better uses for capital in America. However, simply because the current tax system (when combined with the sharp reduction in inflation experienced in the past few years) is overly generous in these areas, it is not correct to infer that we should not subsidize any form of capital accumulation at all. Some types of construction are fairly risky undertakings requiring high degrees of leverage. If we want to keep rents relatively reasonable, and feel that it is more efficient for the government to bear some of the risk of economic cycles, an argument can be made that some subisidization of these types of investments is appropriate (although less than is now provided).

An even stronger case can be made with respect to investment in equipment. If we want American industry to be more competitive worldwide, and it is felt that equipment investment is one of the best ways to leverage America's financial capital, an argument can be made for the retention of of at least some of the investment tax credit. The increased cost of capital that would result from removal of many of the investment incentives, would only further erode our international competitiveness and thus could cause our already staggering trade deficit to become even larger.

CONCLUSIONS AND RECOMMENDATIONS

The bottom line is that the tax reform proposal will lower economic growth in the short term, but it is an open question as to what the long-term impact will be. It depends on whether the benefits from improved incentives and more efficient investment would more than offset the effects of a lower **quantity** of investment spending. In my view, the likelihood that they will be substantial enough to produce the net gains in productivity and economic growth that some have projected is extremely small, especially in view of recent evidence. One way to overcome this problem is to adjust the proposal to provide incentives for both **more** and **better** investment, principally by not shifting the tax burden so heavily from individuals to corporations, and by not completely eliminating some current investment incentives. Unfortunately, however, the House proposal has gone somewhat in the other direction.

Nonetheless, tax reform is a good idea—broadening the tax base by reducing the amount of exclusions, tax deductions, etc., and lowering tax rates simultaneously, is desirable even if it doesn't produce as much future economic growth as some are now claiming. It could make the tax system simpler and a lot fairer, and it could reduce some of the distortions in the economy. But reducing the budget deficit is an even better idea—in fact, perhaps the best way to achieve a healthier and stronger economy is to combine tax reform with deficit reduction. Tax reform should thus be designed in such a way that modest additional tax revenues will result, which, when coupled with additional budget cuts, can put future deficits on a downward trend and remove the pressure of these deficits on financial markets. This would require a somewhat smaller reduction in tax rates than embodied in the President or House proposals, but rates would still be far lower than under current law. This can also be constructed in such a way that most of the increase in revenue would come from those who are not now paying their fair share, which, after all, is one of the major reasons for tax reform in the first place. And, in order to provide more incentives for additional budget cuts in the future, as well as to take advantage of the likelihood that military spending will peak out later in the decade, the package could include a provision which would automatically trigger additional tax rate cuts in the future if deficits are reduced (this would thus be the reverse of the contingency tax increase which the Administration temporarily advocated a while back). This approach would be the best way to achieve the objectives of more economic growth, lower unemployment, and more efficiency, and at the same time produce a fairer and simpler tax system.

Table 1
Present Discounted Value of Depreciation Benefits — $1,000 Investment
Capital Cost Recovery System (CCRS)
Versus Accelerated Cost Recovery System (ACRS)

CCRS Asset Class	Inflation Rate Percent	CCRS	ACRS
1	5	954	908
	10	955	865
2	5	940	837
	10	940	766
3	5	920	837
	10	920	766
4	5	890	837
	10	891	766
5	5	853	707
	10	853	603
6	5	610	570
	10	610	454

Table 2
Comparison of Marginal Tax Rates
Under Current Law and Proposal for 1986
Joint Returns

Current Law		President's Proposal	
Taxable Income	Marginal Tax Rate	Marginal Tax Rate	Taxable Income
Less than $3,670	0	0	Less than $4,000
$3,670 - 5,930	11		
$5,930 - 8,200	12		
$8,200 - 12,840	14		
$12,840 - 17,260	16	15	$4,000 - 29,000
$17,260 - 21,800	18		
$21,800 - 26,540	22		
$26,540 - 32,260	25		
$32,260 - 37,980	28		
$37,980 - 49,420	33	25	$29,000 - 70,000
$49,420 - 64,740	38		
$64,740 - 92,360	42		
$92,360 - 118,040	45		
$118,040 - 175,230	49	35	$70,000 or more
$175,230 or more	50		

Source: Office of the Secretary of the Treasury

Table 3
Marginal Tax Rates for 1986
Current Law and Alternative Proposals
(Joint Return)

Taxable Income	Current Law Tax Rates	President's Proposal	House Proposal
0 - 12,500	0 - 14	0 - 15	0 - 15
12,500 - 22,500	14 - 22	15	15
22,500 - 29,000	22 - 25	15	25
29,000 - 43,000	25 - 33	25	25
43,000 - 70,000	33 - 42	25	35
70,000 - 100,000	42 - 45	35	35
above - 100,000	45 - 50	35	38

NOTE: All schedules have differing allowable personal exemptions and deductions.

Table 4
House Proposed Depreciation System

New Class	Recovery Period (Years)	Equipment Type (ADR Midpoint Life)
1	3	0 - 4.5 years & rental clothing
2	5	5 - 6.5 years & cars, light trucks, telephone switching equipment, and racehorses
3	7	7 - 9.5 years
4	10	10 - 12.5 years & showhorses and n.e.c.
5	13	13 - 15.5 years & some ag. structures
6	16	16 - 19.5 years
7	20	20 - 24.5 years & low income housing
8	25	25 - 29.5 years
9	30	30 - 35.5 years & "moderate" low income housing
10	30	36 years and over & other structures

Depreciation method for classes 1 - 9 is 200% declining balance, switching to straight line depreciation. Depreciation method for class 10 is straight line.

Table 5

Chase Econometrics Long Term Forecast

January 1986 *

	1986	1987	1988	1989	1990
Real GNP (% change)	2.2	2.7	2.9	2.6	2.7
GNP Price Deflator (% change)	2.9	3.4	4.1	4.8	4.9
Unemployment Rate (%)	7.2	7.1	6.8	6.8	6.8
Treasury Bill Rate (%)	6.8	7.2	6.4	6.4	6.5
Investment, Equipment (1982$ % change)	3.2	5.0	4.9	4.9	4.8
Investment Structures (1982$ % change)	2.4	3.0	1.4	2.6	1.2
MultiFamily Housing Starts (Mil. Units)	.59	.59	.54	.53	.53
Single-Fam. Housing Starts (Mil. Units)	1.14	1.19	1.19	1.16	1.14
Corporate Profits After Tax (Billion $)	136.8	126.9	133.7	154.0	145.0
Disposable Income (Billion 1982$)	2553.2	2622.2	2672.8	2735.5	2810.4
Saving Rate (%)	4.2	4.3	3.5	3.2	3.4

*Based on Revised National Income and Product Accounts

Table 6
Estimated Impacts of Tax Reform Proposals

	1985	1986	1987	1988	1989	1990
Gross National Product (Bil. 1982$)						
Baseline	3574.8	3632.9	3732.9	3861.8	3962.2	4069.2
Percent Difference						
President's Tax Reform Proposal		-1.0	-0.7	-0.4	-0.2	-0.2
House Tax Reform Proposal		-0.6	-0.4	-0.2	-0.2	-0.3
Inflation (GNP deflator 1982 = 100)						
Baseline	111.7	114.9	118.8	123.7	129.6	135.9
Percent Difference						
President's Tax Reform Proposal		0.0	-0.2	-0.1	0.0	0.1
House Tax Reform Proposal		-0.1	-0.1	0.1	0.1	0.1
Unemployment Rate (percent)						
Baseline	7.3	7.2	7.1	6.8	6.8	6.8
Actual Difference						
President's Tax Reform Proposal		0.4	0.4	0.3	0.2	0.1
House Tax Reform Proposal		0.2	0.2	0.2	0.1	0.1
Treasury Bill Rate (percent)						
Baseline	7.49	6.83	7.17	6.42	6.4	6.46
Actual Difference						
President's Tax Reform Proposal		-0.45	-0.41	-0.34	-0.21	-0.19
House Tax Reform Proposal		-0.33	-0.25	-0.20	-0.18	-0.16
Investment, Equipment (Bil. 1982$)						
Baseline	304.3	314.1.	329.9	346.2	363.1	380.6
Percent Difference						
President's Tax Reform Proposal		-4.8	-3.1	-2.5	-2.4	-2.2
House Tax Reform Proposal		-4.0	-2.4	-2.4	-2.5	-2.8
Investment, Structures (Bil. 1982$)						
Baseline	165.3	169.2	174.2	176.6	178.7	180.8
Percent Difference						
President's Tax Reform Proposal	-	-10.2	-8.6	-6.3	-5.1	-4.5
House Tax Reform Proposal		-8.0	-5.5	-3.2	-4.1	-6.2
Multifamily Housing Starts (Mil. Units)						
Baseline	0.66	0.59	0.59	0.54	0.53	0.53
Percent Difference						
President's Tax Reform Proposal		-0.20	-0.14	-0.11	-0.09	-0.08
House Tax Reform Proposal		-0.10	-0.05	-0.04	-0.04	-0.04
Single-Family Housing Starts (Mil. Units)						
Baseline	1.07	1.14	1.19	1.19	1.16	1.14
Actual Difference						
President's Tax Reform Proposal		-0.05	-0.03	-0.03	-0.02	-0.01
House Tax Reform Proposal		-0.02	-0.01	0.00	0.00	0.00
Corporate Profits After Taxes (Bil. 1982$)						
Baseline	140.4	136.8	126.9	133.7	154.0	165.0
Actual Difference						
President's Tax Reform Proposal		-21.9	-15.2	-12.4	-10.3	-9.8
House Tax Reform Proposal		-18.1	-3.4	2.5	6.7	9.6
Disposable Income (Bil. 1982$)						
Baseline	2512.4	2553.2	2622.2	2672.8	2735.5	2810.4
Percent Difference						
President's Tax Reform Proposal		0.0	0.3	0.4	0.5	0.6
House Tax Reform Proposal		0.4	0.3	0.5	0.5	0.5
Saving Rate (percent)						
Baseline	4.9	4.2	4.3	3.5	3.2	3.4
Actual Difference						
President's Tax Reform Proposal		0.2	0.4	0.3	0.2	0.2
House Tax Reform Proposal		0.4	0.4	0.2	0.2	0.2

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Figure 1

PROPOSED PERCENTAGE TAX REDUCTION BY
FAMILY ECONOMIC INCOME
(IN THOUSANDS OF DOLLARS)

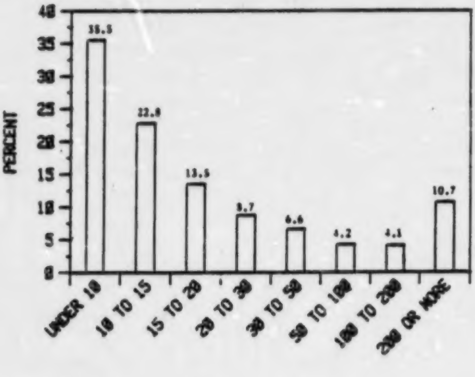
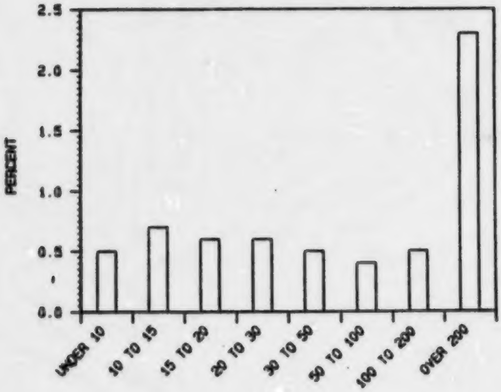


Figure 2

PROPOSED REDUCTION IN TAXES
AS A PERCENT OF FAMILY ECONOMIC INCOME
(IN THOUSANDS OF DOLLARS)



STATEMENT OF ROGER E. BRINNER. PH.D., CHIEF ECONOMIST AND GROUP VICE PRESIDENT, DATA RESOURCES, INC., LEXINGTON, MA

Dr. **Brinner**. Thank you for this opportunity. I will keep my opening remarks fairly brief and hope that, with the testimony in the record and available for your staffs and yourselves, that your questions can highlight to me what you find to be most important, and then I can respond to those questions.

When President Reagan declared that the reform of the personal and corporate income tax structures was a major objective of his administration, the Treasury Department responded by outlining a proposal that was a relatively pure instrument of reform.

In May 1985, the President officially endorsed a revised scheme that included numerous political compromises.

The House Ways and Means Committee was then given the task of creating a formal piece of legislation, and more compromises were made during this process.

If approved as it stands, this bill would enhance the fairness of the Tax Code and slightly reduce the Government's role in private decision making; but this bill would produce a significant loss to the Nation's longrun growth prospects.

The cost of obtaining a fairer Tax Code, however, need not be this high. A narrow set of adjustments would maintain the full improvement and fairness, achieve at least a rate of reduction in Government's role in private decisions, and keep productivity losses to a minimum.

The key adjustment would be a rebalancing of personal and corporate tax changes to keep the reform bill truly revenue neutral and to restore useful investment incentives.

My full testimony, in particular tables 4, 5, and 6, focuses on the problems created by a large personal tax cut and an equal-sized corporate tax increase.

These tables present not only the impacts of the full bill, but also the separate impact of each of these two components.

For example, during the first 5 years on average, one-third of the projected weakness in investment is due to the higher interest rates likely to be produced by a personal tax cut.

Two-thirds of the projected weakness is due to the corporate tax increase.

I hope you find it useful to think about the tax bill as the sum of these two components; and I have some graphs there that help you visualize this as well.

The $25 to $35 billion personal tax cuts should be eliminated by cutting State and local tax deductibility to 50 percent, raising approximately $20 to $25 billion, and by taxing individuals on a similar fraction of their employer paid fringe benefits.

The administration proposed no deductibility of State taxes and substantial inclusion of fringes and taxable income.

A compromise at 50 percent would preserve these valuable reform initiatives.

With respect to the State and local tax deduction, I would argue strongly that no distinction should be made among property, sales, and income taxes.

It has been suggested that perhaps only income and real estate taxes should be deductible. Such discrimination would be a serious mistake because it would put arbitrary unintentional pressure on State and local governments to shift their tax bases in order to help their citizens minimize Federal taxes.

I am also sure that the committee members can recognize the irony in forcing States to shift away from sales taxes just as the Federal Government is considering adopting a national sales tax—a general value added tax, a business transaction tax, or energy use taxes.

All such revenue restored on the personal side should be used to fund an across-the-board 5-percent tax credit for all nonresidential investment.

This would cost approximately $25 billion in 1987 at most.

The inclusion of all structures, along with equipment and utility structures under current law, would provide the tax neutrality sought by many in the administration and Congress.

Investment decisions among types of assets would not be biased because the same credit would be available.

Accelerated depreciation allowances can be scrapped as part of the reform program. They are an inferior incentive to tax credits because their value is so arbitrarily sensitive to volatile inflation and interest rates.

The loss in labor productivity threatened by the House legislation would be avoided with these adjustments because, first, national savings would not be reduced due to the large corporate tax increase and, second, the high-powered investment incentive of a tax credit would be restored.

Business equipment purchases have responded exactly as the econometric models and common sense would predict to the recent blend of tax incentives and high capital costs.

The House bill would raise the average cost of funds for investment by approximately one-half percentage point after tax, from 8.5 to 9 percent, and would raise the total after-tax cost of producers' durable equipment by 17 to 20 percent, utility structures by 15 to 20 percent, and other structures by approximately 5 percent.

These sharp changes would substantially harm the ability of U.S. firms to compete internationally.

The full reform proposed by the House would reduce cumulative business capital stocks by about 1½ percent within a few years.

This loss expands through time into an eventual loss of labor productivity of almost 1½ percent, or approximately $600 per household per year.

This loss can and should be avoided. Exhibit No. 1 in tables 2, 3, and 4 summarizes the causes and dimensions of these problems.

The accompanying exhibits do also indicate that lower marginal tax rates could be expected to increase the supply of hours offered by the labor force, for example, up to 1 percent over the decade.

This is the only supply-side bonus of this whole program. However, this would only tend to keep officially measured output near baseline values as labor is substituted for capital.

Unfortunately, these extra hours would necessarily be drawn from home activities—raising children, cutting lawns, enjoying leisure, et cetera.

These are valuable, but they are not measured as part of the official gross national product.

Therefore, the best measure of gains and losses for the Nation is output per hour, which as I mentioned would fall by almost 1½ percent over the next decade.

The sacrifice of U.S. living standards is unnecessary if the anti-investment flaws of the reform package are amended.

A new minimum tax will protect against abusive use of necessary incentives. A valuable tax reform bill is still within reach of the Senate and the Nation.

Thank you.

The CHAIRMAN. Dr. Brinner, thank you. Dr. Schink.

[The prepared written statement of Dr. Brinner follows:]

DRI Data Resources, Inc.

THE ECONOMIC CONSEQUENCES OF TAX REFORM AS PROPOSED BY THE HOUSE OF REPRESENTATIVES

* * * * * * *

by
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Testimony Before the
Senate Committee of Finance
January 29, 1986

THE ECONOMIC CONSEQUENCES OF TAX REFORM AS PROPOSED BY THE HOUSE OF REPRESENTATIVES

When President Reagan declared that the reform of the personal and corporate income tax structures was a major objective of his administration, the Treasury Department responded by outlining a proposal that was a relatively pure instrument of reform. In May 1985, the President officially endorsed a revised scheme that included numerous political compromises. The House Ways and Means Committee was then given the task of creating a formal piece of legislation, and more compromises were made during this process.

The tax reform legislation proposed by the House of Representatives is thus a blend of several initiatives and features:

- elimination or reduction of a range of tax shelters in order to increase the fairness of the tax code;
- reduction of marginal income tax rates in an effort to discourage tax avoidance, expand incentives to work or invest, and reduce the role of government policy in private decisions;
- reduction of total personal taxes, presumably to obtain political support for the bill given the proposed reduction of shelters, and a corresponding increase in corporate taxes to avoid worsening the already burdensome federal deficit; and
- removal of specific investment incentives such as tax credits and accelerated depreciation.

If approved as it stands, this bill would enhance the fairness of the tax code and slightly reduce the government's role in private decision-making, but this bill would produce a significant loss in the nation's long-run growth prospects.

The cost of obtaining a fairer tax code, however, need not be this high. A narrow set of adjustments would maintain the full improvement in fairness, achieve at least as great a reduction in the government's role in private decisions, and keep productivity losses to a minimum. The key adjustment would be a rebalancing of personal and corporate tax changes to keep the reform bill truly revenue-neutral and to restore useful investment incentives.

The $25-35 billion personal tax cut should be eliminated by cutting state-local tax deductibility to 50% (raising approximately $20-25 billion) and by taxing individuals on a similar fraction of their employer-paid fringe benefits. The administration proposed no deductibility of state taxes and substantial inclusion of fringes in taxable income; a compromise at 50% would preserve these valuable reform initiatives.

All such revenue restored on the personal side should be used to fund an across-the-board 5% tax credit for nonresidential investment (costing $25 billion at most in 1987). The inclusion of all structures--along with equipment and utility structures under current law--would provide the tax neutrality sought by many in the Administration and Congress. investment decisions among types of assets would not be biased because the same credit would be available. Accelerated depreciation allowances can be scrapped as part of the reform program; they are an inferior incentive to tax credits because their value is so arbitrarily sensitive to volative inflation and interest rates. The loss in labor productivity threatened by the House legislation would be avoided with these adjustments because, first, national savings would not be reduced due to a corporate tax increase, and second, the high-powered investment incentive of a tax credit would be restored.

Tax Code Fairness

The central principle underlying the initial Treasury plan was to treat all income equally whether its source was labor, equities, bonds, or real estate. To the extent that income represented a multi-period return, the asset cost would have been indexed to inflation. Incentives to shift income from ordinary tax to capital gains treatment, together with benefits from delayed reporting of current income (such as accelerated depreciation), would have been largely eliminated.

Portions of this approach survived in the President's "Tax Proposals for Fairness, Growth, and Simplicity," led by the simplified 15%-25%-35% rate structure. Inflation adjustments in the measurement of capital gains and of interest income and expense were largely removed--probably a wise choice given the complexity this would have added to the code and the tacit acceptance of permanent inflation (of 5% or better) this would have signified.

The Ways and Means Committee rejected much of the broadening of the tax base proposed in early Reagan Administration drafts. In particular, state and local taxes would remain deductible, as would interest payments on second homes. In place of this Presidentially-proposed base broadening, the Ways and Means Committee sought to achieve fairness by implementing a tough alternative minimum tax. Changes in tax rates and tax brackets proposed by the House Committee also shifted much of the personal tax savings from middle- and upper-income groups to lower-income groups (Table 1).

PROPOSED CHANGES IN TAX LAW

Table I
Income Distribution Data on the Proposal Reforms, 1987*

Income Class (000s of 1986$)	Percentage Change in Income Tax Liability		Percentage Change in After-Tax Income	
	President's Proposal	House Mark-up	President's Proposal	House Mark-up
Less than $10	-72.4	-76.1	1.0	1.0
$10-20	-18.0	-23.4	1.2	1.5
$20-30	-9.3	-9.9	0.9	1.0
$30-40	-6.6	-8.9	0.7	1.0
$40-50	-7.3	-8.4	1.0	1.1
$50-75	-5.9	-7.2	1.0	1.2
$75-100	-8.9	-5.6	1.9	1.2
$100-200	-10.1	-7.2	2.7	1.9
$200 and above	-15.2	-5.8	4.9	1.9
Total	-10.5	-9.0	1.5	1.3

*Preliminary figures from the Joint Committee on Taxation. Released with the caveat.

Prospects for Growth: Capital Investment and Labor-Force Expansion

All of the tax reform plans proposed to date would create large disincentives relative to current law for capital formation by raising the corporate tax burden and by eliminating high-powered investment incentives (Tables 2-3). In the House version, the reduction of the statutory marginal corporate tax rate to 36% is insufficient to offset the cash flow losses created by the removal of the specific investment incentives. The corporate tax bill would rise by an estimated $25-30 billion per year as a net result of all changes in corporate taxation. It will be very unfortunate if this increase is mistakenly deemed to be politically necessary to pay for personal tax cuts brought about by rate reduction.

What the President originally presented as a program of tax reform has evolved into a program of personal tax cuts and corporate tax increases. This is bad enough for capital investment, but the microeconomic incentives for investment have also been reduced. Economists have long agreed that for every dollar of tax revenue foregone by the Treasury, investment tax credits and accelerated depreciation stimulate at least twice the business fixed investment as do cuts in the statutory corporate tax rate. The qualitative logic of this conclusion is quite straightforward (Exhibit 1). A cut in the marginal tax rate costs the Treasury revenues on old investments as well as new. The corporate tax collected on investments made in prior years that are now yielding a income stream is reduced just as much as the tax revenue stream flowing from current and future investments. In contrast, investment tax credits and accelerated depreciation only cost the Treasury revenue on new investments. The investment "bang for the buck" per dollar of Treasury revenue forgone is thus greater for the special incentive programs than for a normal corporate rate change.

Table 2
The Value of Depreciation Allowances

	Pre-1981	Current	Reagan	House
Changes in Depreciation				
	Present Value of Depreciation Per Dollar Purchase Price			
Producers' Durable Equip.	0.75	0.84	0.90	0.74
Utility Structures	0.56	0.64	0.87	0.51
Private Structures	0.35	0.53	0.53	0.35
	After-Tax Value of Depreciation Per Dollar Purchase Price			
Producers' Durable Equip.	0.34	0.39	0.30	0.27
Utility Structures	0.25	0.29	0.29	0.18
Other Structures	0.16	0.24	0.17	0.13
Changes in Investment Tax Credits (%)				
Producers' Durable Equip.	10	10	0	0
Utility Structures	10	10	0	0
Other Structures	0	0	0	0

Table 3
Depreciation Rules Under Current Law and Proposed Reforms*

	Current Law		President's Proposals[a]			House Mark-up[b]		
Representative Asset	Recovery Period	Declining Balance Parameter	Class	Recovery Period	Declining Balance Parameter	Class	Recovery Period	Declining Balance Parameter
Tuxedos	3	1.5	1	4	2.2	1	3	2.0
Cars, Light Trucks, Computers Race Horses, Tractors	3	1.5	2	5	2.2	2	5	2.0
Construction Machinery Mining and Oil Field Machinery	5	1.5	3	6	1.98	3	7	2.0
Metal Working Machinery, General Industrial Machinery, Electrical Machinery, Machinery NEC	5	1.5	4	7	1.54	4	10	2.0
Railroad Equipment, Engines and Turbines	5	1.5	5	10	1.7	5	13	2.0
Ships and Boats	5	1.5	5	10	1.7	6	16	2.0
Gas Facilities	10	1.5	5	10	1.7	7	20	2.0
Very Low Income Housing	15	1.75	6	28	1.12	7	20	2.0
Telephone Facilities, Electric Light and Power	15	1.50	5	10	1.7	8	25	2.0
Railroads	15	1.50	5	10	1.7	9	30	2.0
Moderately Low Income Housing	15	1.75	6	28	1.12	9	30	2.0
All Structures	19	1.75	6	28	1.12	10	30	1.0

[a] In the President's Proposals, the basis is indexed for inflation.

[b] In the House Mark-up, the basis is indexed for half of the amount of inflation that exceeds 5%, if that figure is positive.

* Details on the House Mark-up Bill are not available. This table reports our best guess from publicly available information. 12/5/85

Exhibit 1

The House-Proposed Tax Reform Bill Will Unambiguously Reduce Investment

1. Investment tax credits and accelerated depreciation provide approximately two-to-three times the stimulus to business investment of an equal-sized corporate rate reduction. Therefore, even a revenue-neutral exchange of lower corporate rates for the present investment tax credits and depreciation schedules would have depressed investment.

Changes in Business Capital Stock
in Response to **Hypothetical** Tax Changes
(Percent change relative to base case)

	Quarters After Change					
	4	8	12	16	20	24
Business Capital Stock						
Remove ITC Only	-0.3	-0.8	-1.2	-1.5	-1.4	-1.3
Cut Corporate Rate Only	0.2	0.5	0.6	0.6	0.4	0.3
Do Both (Revenue neutral)	-0.1	-0.3	-0.6	-0.9	-1.0	-1.0

2. The House bill is not revenue-neutral--taxes are dramatically raised for corporations because the rate cut is not steep enough to offset the loss of the investment tax credit and the dilution of depreciation allowances.

Changes in Cash Flow and Investment
in Response to the Proposed **House** Tax Reform Structure
Changes from base case)

	$Billions					% of Base	
	1987	1988	1989	1990	1991	1987-91	1992-96
Corporate Taxes	24.5	22.6	29.1	41.3	59.3	35.6	52.3
Post-Tax Cash Flow	-26.9	-35.3	-42.6	-51.2	-66.5	-9.0	-12.7
Fixed Nonresidential Invest.	-1.7	-8.5	-13.3	-12.8	-6.6	-3.4	-3.6
Equipment	-1.3	-7.1	-11.5	-11.4	-6.0	-4.0	-4.7
Nonutility Structures	-0.4	-1.0	-1.0	-0.5	0.2	-1.0	0.8
Utility Structures	-0.1	-0.4	-0.7	-0.8	-0.8	-4.3	-5.9

Tables 4-6 and Exhibit 2 display quite clearly the negative effects the House tax reform plan would have on capital formation. Similar criticisms apply to both the President's plan and the Treasury's first proposal.

The full reform package would raise consumption by about 0.5% at the end of the first year. This initial strength in household spending would temporarily keep producer durable goods spending only 1% below the base case in spite of weaker corporate cash flow. Spending on both residential and nonresidential construction would immediately and permanently fall below the baseline. By the end of the third year, the cumulative effective capital stock would be about 1.5% lower than in the absence of reform. This translates into an eventual loss of labor productivity of about 1.0-1.5% or $600 per household per year. Certainly, this loss is smaller than might otherwise be the case due to greater efficiency achieved in the allocation of savings among different types of investments, but the net impact is clearly and unambiguously negative.

It may appear that tax reform is not a big event from a macroeconomic point of view; that is, gross output, prices, and interest rates are little changed. The change in the mix of spending, however, is deleterious to the economy. Moreover, price levels would be higher because of the weaker productivity. Interest rates would show little change: lower marginal personal and corporate tax rates would tend to depress pretax interest rates, but higher inflation would tend to raise such interest rates. In addition, the changes in the distribution of the tax burden from the household sector to the corporate sector would depress national saving by about $20 billion per year, raising real interest rates.

The accompanying exhibits indicate that lower marginal tax rates could be expected to increase the supply of hours offered by members of the labor force (e.g., up 1% over a decade). This would tend to keep officially-measured output near the baseline values as labor is substituted for capital. Unfortunately, these extra hours would necessarily be drawn from home activities--raising children, cutting lawns, enjoying leisure, etc.--that are valuable but are not measured as part of official gross national product. Therefore, the best gauge of gains and losses for the nation is output per hour, which would fall by almost 1.5% over the next decade.

A sacrifice of U.S. living standards is unnecessary if the anti-investment flaws of the reform package are mended. The new minimum tax would protect against abusive use of valuable investment incentives. A valuable tax reform bill is still within reach of the Senate and the nation.

Table 4
Impacts of the House Tax Proposal
(Percent difference from baseline unless otherwise indicated)
(All tax changes assumed delayed until January 1, 1987)

	1987	1988	1989	1990	1991	1987-91	1992-96
Supply							
Potential manhours	0.1	0.2	0.3	0.4	0.5	0.3	0.7
Actual manhours	0.1	0.1	0.1	0.2	0.3	0.1	0.1
Business capital stock	-0.1	-0.7	-1.6	-2.2	-2.4	-1.5	-2.9
Number of homes	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.3
Full-employment GNP	0.1	0.1	-0.1	-0.3	-0.3	-0.1	-0.2
Actual output per hour	0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-1.1
Demand							
Consumer Spending	0.6	0.6	0.5	0.6	0.9	0.6	0.6
Fixed investment	-1.0	-3.4	-4.6	-4.1	-2.1	-3.1	-3.4
Residential	-1.7	-3.1	-2.4	-1.4	-0.9	-1.9	-2.3
Nonresidential	-0.8	-3.5	-5.2	-4.8	-2.4	-3.4	-3.6
Equipment	-0.8	-4.0	-6.1	-5.8	-3.0	-4.0	-4.7
Structures	-0.7	-2.2	-2.6	-2.0	-0.8	-1.7	-0.4
Real GNP	0.2	-0.1	-0.2	0.0	0.5	0.1	-0.3
Wages and Prices							
Hourly wages	0.0	0.0	0.0	0.0	0.1	0.0	0.9
Consumer prices	0.0	0.0	0.0	0.1	0.2	0.1	1.1
Real wages	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.2
Wholesale prices	0.0	-0.1	0.0	0.3	0.8	0.2	2.5
Financial Conditions							
Standard & Poor 500 index	-13.1	-13.4	-12.2	-10.7	-9.7	-11.7	-7.7
Dividend yield*	-0.10	-0.26	-0.41	-0.56	-0.73	-0.41	-1.13
Prime rate*	0.15	-0.18	-0.71	-1.15	-1.29	-0.64	-1.07
Mortgage rate*	0.20	0.29	0.14	0.01	-0.05	0.12	0.02
Corporate bond rate*	0.23	0.27	0.12	0.00	-0.05	0.11	0.02
Post-tax cash flow	-6.2	-7.7	-8.7	-9.8	-12.0	-9.0	-12.7
Other Indicators							
Unemployment rate*	-0.1	0.0	0.1	0.0	-0.2	0.0	0.0
Employment	0.2	0.2	0.0	0.1	0.5	0.2	0.3
Industrial production	0.3	-0.4	-0.4	0.4	1.4	0.3	-0.6
Capacity utilization rate	0.3	-0.2	0.4	1.8	3.3	1.1	1.5
Federal Budget							
Taxes**	-1	-10	-5	7	29	4	26
Personal**	-26	-33	-34	-36	-36	-33	-40
Corporate**	24	23	29	41	59	35	53
Expenditures**	0	0	0	-3	-6	-2	2
Interest**	0	0	-1	-3	-6	-2	-15
Deficit**	1	11	4	-10	-35	-6	-24

*Absolute difference in rate
**Absolute difference: billions of dollars

The proposed tax legislation is truly a sum of **two distinct pieces: a personal tax cut** and **a corporate tax increase.** Tables 5-6 and Exhibit 2 portray the macroeconomic impacts of these two components of the total package.

Table 5
Personal Income Tax Impacts of the House Tax Proposal
(Percent difference from baseline unless otherwise indicated)
(All tax changes assumed delayed until January 1, 1987)

	1987	1988	1989	1990	1991	1987-91
Supply						
Potential manhours	0.1	0.2	0.3	0.4	0.5	0.3
Actual manhours	0.2	0.2	0.1	0.1	0.1	0.1
Business capital stock	0.3	0.5	0.4	0.1	-0.2	0.2
Number of homes	-0.1	-0.2	-0.3	-0.4	-0.5	-0.3
Full-employment GNP	0.2	0.5	0.5	0.4	0.3	0.4
Actual output per hour	0.4	0.2	-0.1	-0.3	-0.2	0.0
Demand						
Consumer Spending	1.3	1.7	1.6	1.4	1.3	1.4
Fixed investment	0.7	0.0	-1.3	-2.0	-2.0	-1.0
Residential	-1.6	-4.3	-5.3	-5.0	-4.7	-4.2
Nonresidential	1.4	1.3	-0.2	-1.2	-1.3	-0.1
Equipment	1.9	1.6	-0.2	-1.5	-1.6	-0.1
Structures	0.3	0.4	-0.2	-0.4	-0.3	-0.1
Real GNP	0.9	0.9	0.5	0.3	0.2	0.6
Wages and Prices						
Hourly wages	0.1	0.2	0.4	0.5	0.7	0.4
Consumer prices	0.0	0.2	0.3	0.5	0.7	0.4
Real wages	0.1	0.1	0.1	0.0	-0.1	0.0
Wholesale prices	0.1	0.2	0.2	0.4	0.6	0.3
Financial Conditions						
Standard & Poor 500 index	0.0	-2.9	-3.7	-3.6	-3.3	-2.8
Dividend yield*	0.02	0.02	0.00	-0.03	-0.06	-0.01
Prime rate*	0.50	1.09	1.20	1.09	0.97	0.97
Mortgage rate*	0.36	0.87	1.03	1.08	1.13	0.89
Corporate bond rate*	0.42	0.87	1.01	1.05	1.10	0.89
Post-tax cash flow	0.9	0.1	-0.8	-1.0	-1.0	-0.4
Other Indicators						
Unemployment rate*	-0.2	-0.3	-0.1	0.0	0.1	-0.1
Employment	0.5	0.7	0.4	0.2	0.1	0.4
Industrial production	1.5	0.8	0.0	-0.4	-0.5	0.2
Capacity utilization rate	1.5	0.6	-0.5	-0.7	-0.6	0.0
Federal Budget						
Taxes**	-24	-24	-27	-27	-28	-26
Personal**	-30	-26	-24	-24	-24	-26
Corporate**	4	-2	-7	-7	-7	-4
Expenditures**	1	6	14	22	30	15
Interest**	2	8	13	18	23	13
Deficit**	24	30	41	50	58	41

*Absolute difference in rate
**Absolute difference: billions of dollars

Table 6
Corporate Income Tax Impacts of the House Tax Proposal
(Percent difference from baseline unless otherwise indicated)
(All tax changes assumed delayed until January 1, 1987)

	1987	1988	1989	1990	1991	1987-91
Supply						
Potential manhours	0.0	0.0	0.0	0.0	0.0	0.0
Actual manhours	-0.1	-0.1	0.0	0.1	0.1	0.0
Business capital stock	-0.3	-1.1	-1.9	-2.4	-2.3	-1.6
Number of homes	0.0	0.0	0.1	0.2	0.2	0.1
Full-employment GNP	-0.1	-0.3	-0.6	-0.7	-0.7	-0.5
Actual output per hour	-0.2	-0.3	-0.1	0.1	0.2	-0.1
Demand						
Consumer Spending	-0.4	-1.0	-1.1	-0.9	-0.6	-0.8
Fixed investment	-1.3	-3.5	-3.8	-2.4	-0.1	-2.2
Residential	-0.1	0.6	2.4	3.5	3.8	2.0
Nonresidential	-1.7	-4.7	-5.4	-4.0	-1.1	-3.3
Equipment	-1.9	-5.4	-6.4	-4.8	-1.4	-4.0
Structures	-0.9	-2.5	-2.5	-1.6	-0.3	-1.5
Real GNP	-0.5	-1.0	-0.9	-0.5	0.2	-0.5
Wages and Prices						
Hourly wages	0.0	-0.2	-0.4	-0.6	-0.6	-0.4
Consumer prices	0.0	-0.1	-0.3	-0.5	-0.6	-0.3
Real wages	0.0	-0.1	-0.1	-0.1	0.0	-0.1
Wholesale prices	-0.1	-0.3	-0.3	-0.2	0.2	-0.1
Financial Conditions						
Standard & Poor 500 index	-13.1	-11.6	-9.4	-7.7	-6.5	-9.4
Dividend yield*	-0.13	-0.32	-0.45	-0.57	-0.69	-0.43
Prime rate*	-0.23	-1.10	-1.87	-2.29	-2.34	-1.56
Mortgage rate*	-0.08	-0.46	-0.83	-1.06	-1.21	-0.73
Corporate bond rate*	-0.11	-0.49	-0.84	-1.05	-1.19	-0.73
Post-tax cash flow	-6.6	-7.5	-7.6	-8.1	-9.7	-8.0
Other Indicators						
Unemployment rate*	0.1	0.4	0.3	0.1	-0.3	0.1
Employment	-0.1	-0.5	-0.5	-0.2	0.3	-0.2
Industrial production	-0.8	-1.5	-0.8	0.5	1.8	-0.1
Capacity utilization rate	-0.8	-1.2	0.3	2.3	3.9	0.9
Federal Budget						
Taxes**	19	12	18	32	55	27
Personal**	-2	-8	-12	-14	-14	-13
Corporate**	22	23	34	49	70	40
Expenditures**	-1	-4	-12	-23	-34	-15
Interest**	-1	-6	-12	-19	-27	-13
Deficit**	-19	-16	-30	-55	-89	-42

*Absolute difference in rate

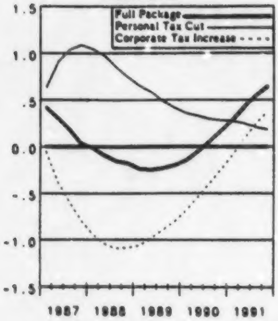
**Absolute difference: billions of dollars

Exhibit 2
IMPACTS OF TAX REFORM

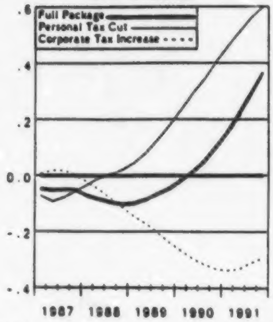
Ways and Means Committee Version
Output, Prices, and Government Finances

(Percent difference from baseline)

Real GNP

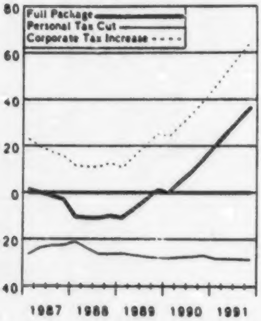


GNP Deflator

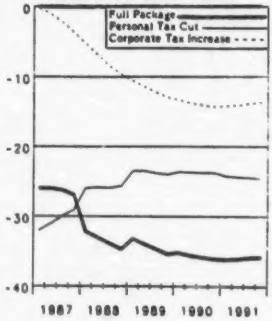


(Billions of dollars change)

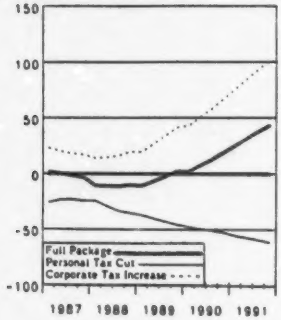
Federal Taxes



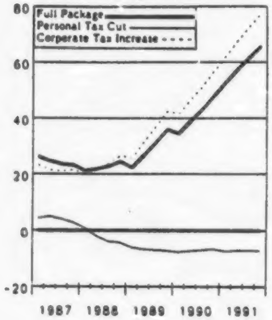
Federal Personal Taxes



Federal Surplus (Expenditures minus Revenues)



Federal Corporate Taxes

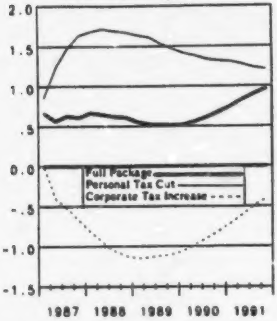


IMPACTS OF TAX REFORM (continued)

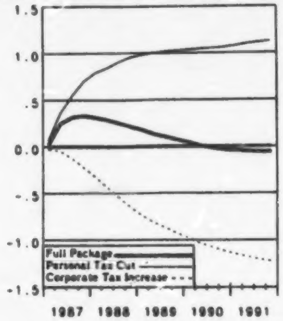
Spending and Capital Formation

(Percentage differences from baseline)

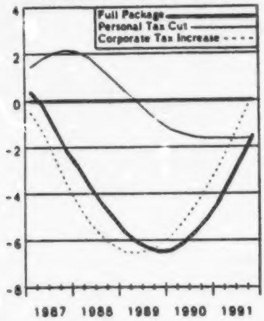
Real Consumption



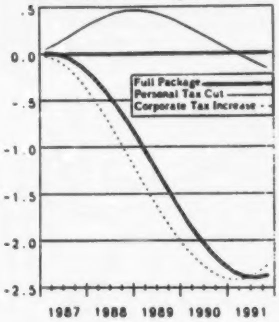
Corporate Bond Rate (Percentage point change)



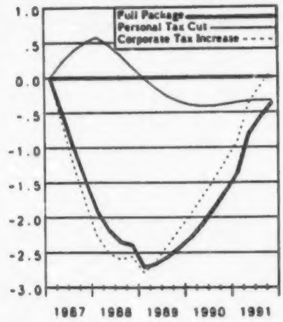
Real Producer Durables



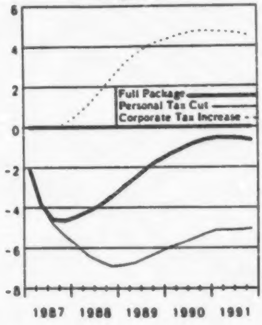
Real Effective Capital Stock



Real Nonresidential Construction



Housing Starts



STATEMENT OF GEORGE SCHINK, PH.D., VICE PRESIDENT FOR RESEARCH AND DEVELOPMENT, WHARTON ECONOMETRIC FORECASTING ASSOCIATES, INC., PHILADELPHIA, PA

Dr. **Schink.** Mr. Chairman and distinguished members of the committee, I am pleased to have this opportunity to discuss the views of Wharton Econometrics regarding both the administration's tax reform proposal and the bill as enacted by the House.

The stated objectives behind the administration's tax reform proposals and behind those as implemented in the Tax Reform Act are laudable.

It is very difficult to oppose the desire to simplify the tax laws, to make the tax laws more equitable by eliminating in essence loopholes and to improve the efficiency of the U.S. economy.

And Wharton Econometrics certainly endorses these objectives.

The problem that we see with both the administration's tax reform proposals and the Tax Reform Act are that they fall short of meeting these objectives, and they have serious negative impacts on the longer term growth potential of the U.S. economy.

While my testimony which was submitted earlier, and has tables, et cetera, was focused on the specific implications of the Tax Reform Act as passed by the House, Wharton's prior analysis of the administration's tax reform proposals, both Treasury I and Treasury II, have reached in essence similar conclusions.

We have concluded the Tax Reform Act fails to really noticeably simplify the Tax Code and it does eliminate some of the tax loopholes, and this is certainly laudible, but it leaves many intact.

It is not clear whether the tax savings associated with closing loopholes would be realized as other ones might be exploited.

And most seriously, the Tax Reform Act leads to a reduction in business investment. This reduced investment leads to high unit labor costs. High unit labor costs lead to higher prices and ultimately make the United States less competitive in the international marketplace.

This loss of international competitiveness and the reduced capital per worker, I think, combine to reduce the longer term growth potential of the U.S. economy and, in essence, reduce our standard of living in the longer term.

The key impacts of the Tax Reform Act, in terms of how it is going about things, is to broaden the tax base and to lower rates; and it certainly has an objective to include more income in the base and to then tax this greater base at a lower rate, I think, is a laudible objective.

I think where the specific implementation falls short, as my colleagues I think have concurred, is that personal taxes are cut substantially while business or corporate taxes are raised substantially.

Now, the obvious implications of the cut in personal taxes and the, in essence, offsetting increase in corporate taxes are that consumer spending will rise because individuals in essence have more after-tax income to spend, while corporate spending on investment will fall, in part because of a reduction in cash-flow but also due to the design of the bill to reduce the after-tax rate of return of investment.

Now, the Tax Reform Act would have a strong negative impact both on housing and on business investment.

Now, the housing investment would be reduced because the cost of homeownership would rise absolutely and, at least initially, relative to rental costs.

At the same time, the after-tax return to investment on rental housing would be reduced. This would lead to a sharp drop in multifamily unit starts, which would not really see a rebound until rental rates on housing rose to a point where the return to potential investors was sufficient to do this, to encourage this investment.

Business investment would be down primarily because the investment tax credit is eliminated, depreciation of capital assets would be less rapid than under current law, and after-tax corporate income and cash-flow would be reduced.

Now, the primary reason for the tax increase on corporations is the result of reducing, in essence, or changing the provisions which reduce the incentive to invest.

The overall economic implications of implementing the tax reform bill, I think, should be looked at in two episodes.

During the first 5 years after implementation, or the period which has been most carefully studied, I think, or completely studied, one would expect the total output GNP to be higher, but this is because consumer spending is up.

We have estimated that over the first 5 years, whiie personal savings is up by 3 percentage points—our estimate is that the average rate would rise from about 4.6 to 4.9 percent—most of the tax cut flows into consumer spending, which would be up on average of about 1 percent.

The two components of investment would be down. Housing would be down initially, fairly significantly, about 3 percent on average during each of the first few years, with housing starts being down by as much as 250,000 units at the low point.

Business investment would be down on average by about 1.6 percent during the first 5 years; and the net impact on GNP during this period would be a slight increase of about three-tenths of 1 percent.

So, the increase in consumer spending is sufficient to push output up during the initial 5-year period; but the reduction in business investment reduces the productivity potential in international competitiveness leading in the period beyond the first 5 years to a reversal of the situation.

Real GNP in the sixth through ninth years, by our calculations, would be down by about three-tenths of 1 percent per year.

Consumer spending would remain higher because tax rates are still lower, but it would be only up by about four-tenths of 1 percent, versus 1 percent.

Residential investment remains down by approximately 3 percent, and business investment is now down on average by about 3 percent.

There are longer lags, we feel, in the adjustment of business spending to the changes in the tax laws in either consumer or residential spending, but the impacts in the long run I think are very substantial on business investment.

Wharton Econometrics has a great deal of difficulty supporting the twist in the tax structure away from persons and toward corporations.

In many earlier periods when tax reform was discussed, quite often the discussion was to shift the burden of taxation more away from business to individuals because ultimately individuals end up paying the taxes in one form or another.

The hidden form in which consumers, I think, pay the tax in this instance is that the reduced business investment reduces the growth potential and their income in the longer run and makes our industry less competitive internationally, both in terms of our ability to compete in our own marketplace with foreign competitors and in terms of our ability to compete in third markets with other developed country competitors.

The other aspect of the bill, which we have a good deal of difficulty with, is its movement away from supporting housing investment.

The House bill kept in certain provisions which were favorable to low-income housing but, nonetheless, has the overall effect of raising the cost of housing for everybody, both homeowners and renters, and to reduce the amount of housing being constructed.

Thank you.

The CHAIRMAN. Thank you.

[The prepared written statement of Dr. Schink follows:]

THE ECONOMIC IMPACTS
OF IMPLEMENTING THE
TAX REFORM ACT OF 1985 (H.R. 3838)

STATEMENT OF

GEORGE R. SCHINK
VICE PRESIDENT, RESEARCH AND DEVELOPMENT

WHARTON ECONOMETRIC FORECASTING ASSOCIATES, INC.
3624 SCIENCE CENTER
PHILADELPHIA, PENNSYLVANIA 19104

BEFORE THE

SENATE COMMITTEE ON FINANCE

U.S. SENATE
ROOM SD-219
DIRKSEN SENATE OFFICE BUILDING
WASHINGTON, D.C. 20510

JANUARY 29, 1986

SUMMARY AND INTRODUCTION

Mr. Chairman, I am pleased to appear before this committee to discuss the views of Wharton Econometrics regarding the economic impacts of implementing H.R. 3838 (hereinafter the Tax Reform Act).

The Tax Reform Act makes changes to the existing tax structure which are qualitatively similar to those put forth in the President's tax reform proposals. The major impacts on the structure of the Tax Reform Act are that

- the tax base is broadened while tax rates are lowered;
- personal taxes are cut on average; and
- corporate taxes are raised on average.

The above changes in the average effective tax rates place more money in the hands of consumers, thereby encouraging consumer spending, and reduce the after-tax income of corporations, thereby discouraging business investment. The changes in the tax law also raise the cost of owner-occupied housing and, at current rental rates, reduce the rate of return on rental housing. As a result, residential investment is reduced. This ultimately raises the cost of housing for renters as well as for owners.

The net macroeconomic impacts of implementing the Tax Reform Act would be that:

- Real consumer spending would be higher than under current tax law (the baseline);
- Business spending on plant and equipment would be lower than under the baseline;

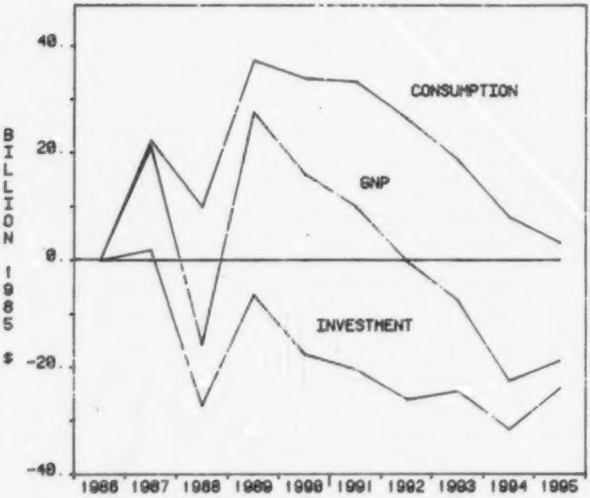
- Residential investment (housing starts) would be lower than under the baseline; and

- Real GNP, on average, would be higher than under the baseline for the first five years, but real GNP would be lower than under the baseline thereafter.

Figure 1 illustrates the effect of implementing the Tax Reform Act on real consumer spending, investment (business plus residential) and on GNP over the 1987-95 period, assuming the Tax Reform Act were implemented as of January 1, 1987.

FIGURE 1

GNP IS, ON AVERAGE, INITIALLY HIGHER,
BUT THEN FALLS BECAUSE THE INVESTMENT
SLUMP CANCELS EARLY CONSUMER GAINS



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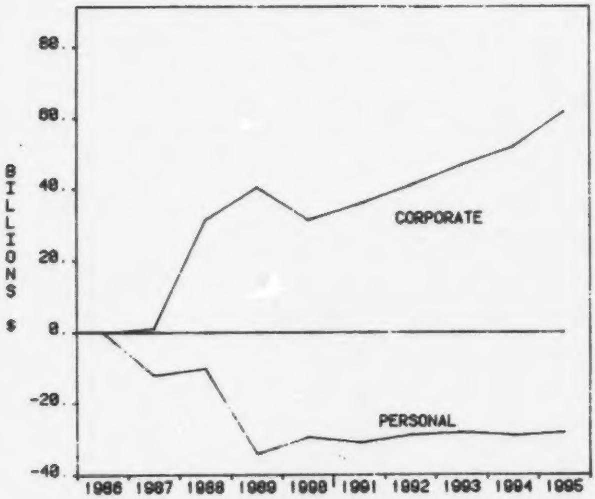
The sustained slump in business investment reduces labor productivity and eventually leads to slightly higher price levels and interest rates. Price levels are kept from being even higher due to weakened economic growth. After a five year period, the overall price level is only 0.5 percent above the baseline.

Our analysis indicates that the Tax Reform Act would not be revenue neutral. The staff of the Joint Committee on Taxation estimated that the cumulative impact on the federal deficit during the first five years after the Tax Reform Act was implemented would be minor. (The cumulative impact was estimated to be a $0.4 billion increase in the federal deficit.) Wharton's simulations indicate that the increase in business tax receipts would more than offset the reduction in personal tax receipts. During the first five years after the Tax Reform Act was implemented, we estimate that the cumulative reduction in the federal deficit would be $33.4 billion. Figure 2 contrasts the increase in federal corporate tax receipts with the reductions in federal personal tax receipts.

The results presented here for H.R. 3838 are consistent with our previous analysis of the President's tax reform proposals. These results indicate that cutting taxes for consumers and raising taxes on business leads to a short-term increase in consumer spending and output, but these short-term gains to the consumer come at the expense of investment in productive capital. This reduction in investment leads to a decline in productivity, somewhat higher prices, and, eventually, to lower levels of output.

FIGURE 2

BUSINESS TAXES ARE RAISED MORE
THAN PERSONAL TAXES ARE CUT



Wharton's analysis of H.R. 3838 was conducted using Wharton's Long-Term Model of the U.S. economy. The analysis assumed H.R. 3838 would be implemented to be effective on January 1, 1987, rather than January 1, 1986. An earlier implementation would not alter the conclusions.

CHANGES IN PERSONAL TAXES

The major provisions of H.R. 3838 relating to taxes on individuals include:

- collapsing 14 tax brackets rates ranging from 11 to 50 percent to 4 bracket rates of 15, 25, 35, and 38 percent;
- raising the personal exemption from the current $1080 to $2000 for non-itemizers and to $1500 for itemizers;
- increasing the standard deduction from $3,670 to $4,800 for joint returns, from $2,480 to $4,200 for heads of households, and from $2,480 to $2,950 for unmarried individuals;
- retaining the deductibility of all mortgage interest payments but placing a limit on additional interest payments of $10,000 ($20,000 on joint returns) above investment income;
- repealing the at-risk exclusion for real estate investment;
- retaining the deductibility of state and local taxes;
- maintaining the current limits on IRA contributions;
- tightening up the provisions affecting charitable contributions, entertainment and travel expenses, and 401(K) contributions;
- treating income on assets transferred to minor children as income of the parents;
- eliminating the two-earner deduction and the partial exclusion of unemployment benefits; and
- strengthening the minimum tax provisions by raising the rate from 20 percent to 25 percent and by requiring more tax preference items to be added into the base.

The latter provision will have the effect of abrogating the potential tax savings stemming from many of the tax preference items which have not been eliminated by H.R. 3838.

The net effect of the personal tax law changes is to reduce the effective federal personal income tax rate. The staff of the Joint Committee on Taxation estimated that during the five years after H.R. 3838 was enacted, cumulative taxes on individuals would be reduced by $139.8 billion. Wharton estimates that the cumulative reduction in personal taxes during the first five years would be $116.9 billion.

While Wharton's estimate of the value of the personal tax cut falls short of that put forth by the Joint Committee staff, the reduction is still very substantial. As a result, cumulative real consumer spending increases relative to baseline levels during the 1987-91 period by $136.1 billion 1985 dollars (or by 1.0 percent above baseline levels). The tax cut also generates an increase in personal savings; over the 1987-91 period, the personal savings rate is higher, on average, by 0.3 percentage points. Therefore, while the tax cut does generate some additional personal savings, most of the tax cut flows into higher levels of consumer spending.

IMPACTS ON THE HOUSING SECTOR

The proposed changes in the personal tax rates and rules also have a significant impact on the housing sector of the economy. The cut in the marginal tax rate combined with the increases in standard deductions raise the cost of homeownership absolutely and relative to renting. This relative cost change would be permanent, leading to a reduced demand for owner-occupied units. In turn, this would lead to a one-time drop in the value of the owner-occupied housing stock and a loss in net worth for many homeowners.

The proposed changes in the tax laws also substantially reduce the after-tax rate of return on rental properties by reducing the value of depreciation allowances permitted, placing an upper limit on non-business interest expenses, eliminating the at-risk exclusion for real estate, strengthening the minimum tax provisions, and by reducing the maximum marginal tax rate (thereby reducing the value of the tax savings associated with real estate investment). This decline in after-tax return on rental properties will reduce investment in rental properties until rental rates increase by enough to bring the rate of return on rental property investment back to competitive levels.

Rental rates should climb fairly rapidly as more of the households opt for rental units, given the initial relative rise in homeownership costs and the cutback in rental property investment. The net result will be significantly higher housing costs for all consumers. This result stems from the fact that the current tax structure offers strong incentives for both homeownership and for the development of rental properties, and H.R. 3838 eliminates many of these incentives, though it does retain favorable treatment for low-income rental housing.

Cumulative real residential investment under H.R. 3838 would be $25.2 billion 1985 dollars below its baseline level over the 1987-91 period (or 3.0 percent, on average, below baseline levels). Housing starts fall below baseline levels by as much as 250,000 units (in 1988). Further, we are still evaluating the details of the impacts of H.R. 3838 on the housing sector and believe that the results presented here are conservative.

CHANGES IN CORPORATE TAXES

The key provisions of H.R. 3838 pertaining to corporations include:

- reducing the top corporate tax rate from 46% to 36%;
- allowing deduction of 10% of dividends paid;
- providing for less rapid depreciation of assets, compared with ACRS, but partially indexing the depreciation deductions;
- repealing the investment tax credit;
- reducing the capital gains exclusion from 60% to 42%;
- restricting some of the tax breaks in the oil and financial industries; and
- strengthening the minimum tax provisions to offset part of the value of the remaining tax preference items.

The net effect of the above changes is to raise the effective rate of corporate taxation. Over the 1987-91 period, Wharton estimates that cumulative corporate tax collections will increase by $140.2 billion which is very close to the $138.9 billion increase estimated by the staff of the Joint Committee on Taxation (for the first five years after H.R. 3838 was enacted).

The increase in corporate taxes is due primarily to eliminating the investment tax credit and allowing a less rapid depreciation of assets than is now possible under ACRS. These changes in the tax laws also reduce the after-tax rate of return on business investment in plant and equipment, thereby discouraging investment activity. Economists have developed a concept of the cost of capital to summarize the net impact of tax changes on investment incentives. The cost of capital is the before-tax rate of return that an investment must yield to cover the after-tax cost of funds to the firm.

Table 1 shows the increase in capital costs by industry as of 1995 due to implementing H.R. 3838. The average increase in the cost of capital is 12.5 percent. This increase in the cost of capital leads to a reduction in business investment and thereby to a reduction in the productive capital stock. Over the 1987-95 period, real business investment is $124.2 billion 1985 dollars less due to implementing H.R. 3838, which is 2.3 percent less than baseline levels.

TABLE 1

PERCENTAGE CHANGES IN CAPITAL STOCK AND THE COST OF CAPITAL IN 1995

	Capital Stock	Cost of Capital
All Industries	-1.5	---
Agriculture	-3.5	13.5
Mining	-1.2	11.3
Durable Manufacturing	-2.1	---
Lumber	-0.7	17.9
Furniture	-12.1	11.9
Stone, Clay and Glass	-3.0	16.4
Primary Metals	-3.3	14.9
Fabricated Metal Products	-11.6	14.9
Nonelectrical Machinery	-2.3	13.0
Electrical Machinery	-0.2	13.3
Motor Vehicles	-1.2	13.6
Nonauto Trans Eq & Misc Manuf	-0.4	14.0
Instruments	-0.3	11.2
Nondurable Manufacturing	-0.6	---
Food and Beverages	0.9	12.3
Tobacco	0.0	10.8
Textiles	-0.7	15.5
Apparel	-2.4	14.1
Paper	-1.7	15.4
Printing and Publishing	-5.4	16.0
Chemicals	-1.0	15.5
Petroleum	0.2	10.8
Rubber	-0.4	15.1
Leather	-0.1	13.5
Transportation	-9.2	10.3
Utilities	0.2	16.9
Communications	-0.7	2.3
Commercial	-1.8	5.5

SUMMARY OF REAL MACROECONOMIC EFFECTS

The most serious long-run negative macroeconomic impacts of H.R. 3838 stem from the induced reduction in business investment. This reduction of investment translates into reduced productive capacity, higher unit labor costs, and higher prices. These negative impacts become more serious over time. The overall longer-run negative impacts of H.R. 3838 are best illustrated by the following comparison of average annual differences in real GNP and its major components over the 1987-91 period versus the 1992-95 period.

	Average Annual Difference From Baseline (Billions of 1985 $)	
	1987-91	1992-95
Real GNP	12.0	-12.6
Personal Consumption	27.2	14.0
Residential Investment	-5.0	-5.3
Business Investment	-8.9	-19.9
All Other Expenditures	-1.3	-1.4

APPENDIX

COMPARISON OF H.R. 3838 TAX REFORM PLAN WITH BASELINE SCENARIO

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                                                  THE WHARTON LONG-TERM MODEL
                                        TAX REFORM PROPOSAL VS. DECEMBER 1985 BASELINE

                                                TABLE 1.00 SELECTED INDICATORS
-------------------------------------------------------------------------------------------------------------------------------
|              |                                   |  1985    1986    1987    1988    1989    1990    1991    1992    1993    1994    1995|
-------------------------------------------------------------------------------------------------------------------------------
 1|GNP$        |GROSS NATIONAL PRODUCT (CUR $)------|                                                                                 |
 2|            |TAX PROPOSAL-----------------------|   3887    4123    4462    4747    5183    5452    5963    6368    6831    7340    7924|
 3|            |BASELINE---------------------------|   3887    4123    4440    4764    5152    5424    5936    6337    6805    7337    7919|
 4|            |DIFFERENCE-------------------------|      0       0      22     -17      31      28      28      30      26       4       5|
 5|            |% DIFF-----------------------------|      0       0       0       0       1       1       0       0       0       0       0|
 6|RGNP$       |                          % CHANGE|                                                                                 |
 7|            |TAX PROPOSAL-----------------------|    6.1     6.1     8.2     6.4     9.2     5.2     9.4     6.8     7.3     7.5     7.9|
 8|            |BASELINE---------------------------|    6.1     6.1     7.7     7.3     8.1     5.3     9.4     6.8     7.4     7.8     7.9|
 9|            |DIFFERENCE-------------------------|     .0      .0      .5     -.9     1.0     -.1     -.1      .0     -.1     -.4      .0|
10|            |% DIFF-----------------------------|     .0      .0     6.9   -12.5    12.8    -1.5     -.6      .1    -1.4    -4.5      .2|
11|            |                                   |                                                                                 |
12|GNP         |GROSS NATIONAL PRODUCT (72 $)-------|                                                                                 |
13|            |TAX PROPOSAL-----------------------|1680.2  1724.7  1793.6  1830.1  1902.3  1896.1  1998.8  2054.6  2112.1  2172.7  2237.4|
14|            |BASELINE---------------------------|1680.2  1724.7  1784.3  1837.0  1890.2  1889.1  1994.4  2054.8  2115.4  2182.6  2245.6|
15|            |DIFFERENCE-------------------------|     .0      .0     9.3    -6.9    12.1     7.1     4.4     -.1    -3.4   -10.0    -8.2|
16|            |% DIFF-----------------------------|     .0      .0      .5     -.4      .6      .4      .2      .0     -.2     -.5     -.4|
17|RGNP        |                          % CHANGE|                                                                                 |
18|            |TAX PROPOSAL-----------------------|    2.5     2.6     4.0     2.0     3.9     -.3     5.4     2.9     2.8     2.9     3.0|
19|            |BASELINE---------------------------|    2.5     2.6     3.5     3.0     2.9     -.1     5.6     3.0     3.0     3.2     2.9|
20|            |DIFFERENCE-------------------------|     .0      .0      .5     -.9     1.1     -.3     -.2     -.2     -.2     -.3      .1|
21|            |% DIFF-----------------------------|     .1      .0    15.6   -31.1    38.3   438.8    -3.0    -7.7    -5.3    -8.7     3.2|
22|            |                                   |                                                                                 |
23|PDGNP       |GROSS NAT. PROD. DEFL. (1972=100.0)|                                                                                 |
24|            |TAX PROPOSAL-----------------------|  231.4   239.1   248.8   259.4   272.5   287.5   298.4   309.9   323.4   337.9   354.2|
25|            |BASELINE---------------------------|  231.4   239.1   248.8   259.4   272.6   287.1   297.6   308.4   321.7   336.1   352.6|
26|            |DIFFERENCE-------------------------|     .0      .0     -.1      .0     -.1      .4      .7     1.5     1.6     1.7     1.5|
27|            |% DIFF-----------------------------|     .0      .0      .0      .0      .0      .1      .2      .5      .5      .5      .4|
28|RPDGNP      |                          % CHANGE|                                                                                 |
29|            |TAX PROPOSAL-----------------------|    3.5     3.3     4.1     4.3     5.0     5.5     3.8     3.8     4.4     4.5     4.8|
30|            |BASELINE---------------------------|    3.5     3.3     4.1     4.2     5.1     5.3     3.6     3.6     4.3     4.5     4.9|
31|            |DIFFERENCE-------------------------|     .0      .0      .0      .0     -.1      .2      .1      .2      .1      .0     -.1|
32|            |% DIFF-----------------------------|     .0      .0     -.7     1.0    -1.2     3.7     3.0     6.7     1.4     -.8    -1.8|
33|            |                                   |                                                                                 |
34|NPT         |POPULATION (MILLIONS)--------------|                                                                                 |
35|            |TAX PROPOSAL-----------------------|240.01  242.45  244.86  247.26  249.64  251.99  254.19  256.36  258.50  260.60  262.67|
36|            |BASELINE---------------------------|240.01  242.45  244.86  247.26  249.64  251.99  254.19  256.36  258.50  260.60  262.67|
37|            |DIFFERENCE-------------------------|    .00     .00     .00     .00     .00     .00     .00     .00     .00     .00     .00|
38|            |% DIFF-----------------------------|    .00     .00     .00     .00     .00     .00     .00     .00     .00     .00     .00|
39|NPT         |                          % CHANGE|                                                                                 |
40|            |TAX PROPOSAL-----------------------|    1.0     1.0     1.0     1.0     1.0      .9      .9      .9      .8      .8      .8|
41|            |BASELINE---------------------------|    1.0     1.0     1.0     1.0     1.0      .9      .9      .9      .8      .8      .8|
42|            |DIFFERENCE-------------------------|     .0      .0      .0      .0      .0      .0      .0      .0      .0      .0      .0|
43|            |% DIFF-----------------------------|     .0      .0      .0      .0      .0      .0      .0      .0      .0      .0      .0|
44|            |                                   |                                                                                 |
45|NLC         |LABOR FORCE (MILLIONS)-------------|                                                                                 |
46|            |TAX PROPOSAL-----------------------|115.46  117.41  119.29  121.10  122.77  124.48  126.19  127.72  129.25  130.77  132.29|
47|            |BASELINE---------------------------|115.46  117.41  119.30  121.08  122.77  124.44  126.16  127.65  129.18  130.70  132.25|
48|            |DIFFERENCE-------------------------|    .00     .00    -.01     .02     .00     .04     .03     .07     .07     .07     .04|
49|            |% DIFF-----------------------------|    .00     .00    -.01     .02     .00     .03     .03     .06     .05     .05     .03|
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THE WHARTON LONG-TERM MODEL
TAX REFORM PROPOSAL VS. DECEMBER 1985 BASELINE

TABLE 1.00 SELECTED INDICATORS

			1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1	NLC	% CHANGE											
2		TAX PROPOSAL	1.7	1.7	1.6	1.5	1.4	1.4	1.4	1.2	1.2	1.2	1.2
3		BASELINE	1.7	1.7	1.6	1.5	1.4	1.4	1.4	1.2	1.2	1.2	1.2
4		DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
5		% DIFF	.0	.0	-.5	1.6	-1.1	2.1	-.3	2.5	.0	-.4	-1.7
6													
7	NRLC*	PARTICIPATION RATE											
8		TAX PROPOSAL	64.4	64.7	65.0	65.3	65.6	65.8	66.0	66.2	66.4	66.5	66.7
9		BASELINE	64.4	64.7	65.1	65.3	65.5	65.8	66.0	66.2	66.3	66.5	66.6
10		DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
11		% DIFF	.0	.0	.0	.0	.0	.0	.0	.1	.1	.0	.0
12	NRLC*	% CHANGE											
13		TAX PROPOSAL	.0	.5	.5	.4	.3	.4	.4	.2	.2	.2	.2
14		BASELINE	.0	.5	.5	.4	.3	.3	.4	.2	.2	.2	.2
15		DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
16		% DIFF	-.5	.0	-1.5	5.8	-4.2	8.5	-1.1	13.5	-.2	-2.0	-8.3
17													
18	NEMT	EMPLOYMENT (MILLIONS)											
19		TAX PROPOSAL	107.08	108.84	111.44	112.89	114.99	114.76	117.99	119.66	121.18	122.72	124.33
20		BASELINE	107.08	108.84	111.21	112.91	114.68	114.33	117.52	119.24	120.82	122.53	124.19
21		DIFFERENCE	.00	.00	.23	-.02	.31	.43	.47	.42	.36	.19	.14
22		% DIFF	.00	.00	.21	-.02	.27	.38	.40	.36	.30	.16	.11
23	NEMT	% CHANGE											
24		TAX PROPOSAL	2.0	1.6	2.4	1.3	1.9	-.2	2.8	1.4	1.3	1.3	1.3
25		BASELINE	2.0	1.6	2.2	1.5	1.6	-.3	2.8	1.5	1.3	1.4	1.4
26		DIFFERENCE	.0	.0	.2	-.2	.3	.1	.0	.0	-.1	-.1	.0
27		% DIFF	.0	.0	9.9	-15.2	18.4	-36.0	.9	-3.1	-4.5	-10.2	-3.1
28													
29	WRC$	WAGE RATE PER WEEK, ALL INDUSTRIES											
30		TAX PROPOSAL	417.1	437.8	463.2	488.8	520.7	560.4	587.3	620.5	660.4	702.8	749.6
31		BASELINE	417.1	437.8	462.7	488.2	519.8	558.5	584.2	616.5	656.6	699.9	747.7
32		DIFFERENCE	.0	.0	.5	.6	.9	1.9	3.1	4.0	3.8	3.0	1.9
33		% DIFF	.0	.0	.1	.1	.2	.3	.5	.6	.6	.4	.3
34	WRC$	% CHANGE											
35		TAX PROPOSAL	4.8	4.9	5.8	5.5	6.5	7.6	4.8	5.7	6.4	6.4	6.7
36		BASELINE	4.8	4.9	5.7	5.5	6.5	7.4	4.6	5.5	6.5	6.6	6.9
37		DIFFERENCE	.0	.0	.1	.0	.0	.2	.2	.1	-.1	-.2	-.2
38		% DIFF	.0	.0	2.1	.3	.6	2.6	4.1	2.3	-1.3	-2.4	-2.6
39													
40	GNPPP	PRODUCTIVITY - ALL INDUSTRIES											
41		TAX PROPOSAL	15.692	15.846	16.094	16.212	16.544	16.523	16.941	17.170	17.430	17.704	17.995
42		BASELINE	15.691	15.846	16.045	16.270	16.483	16.523	16.972	17.233	17.509	17.813	18.082
43		DIFFERENCE	.000	.000	.050	-.058	.062	.000	-.031	-.062	-.080	-.108	-.087
44		% DIFF	.001	.001	.310	-.359	.374	-.002	-.182	-.362	-.454	-.609	-.479
45	GNPPP	% CHANGE											
46		TAX PROPOSAL	.5	1.0	1.6	.7	2.1	-.1	2.5	1.4	1.5	1.6	1.6
47		BASELINE	.5	1.0	1.3	1.4	1.3	.2	2.7	1.5	1.6	1.7	1.5
48		DIFFERENCE	.0	.0	.3	-.7	.7	-.4	-.2	-.2	-.1	-.2	.1
49		% DIFF	.1	.0	25.0	-48.1	56.9	-153.0	-6.8	-11.9	-5.9	-9.1	8.7
50													

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THE WHARTON LONG-TERM MODEL
TAX REFORM PROPOSAL VS. DECEMBER 1985 BASELINE

TABLE 1.00 SELECTED INDICATORS

			1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1	XMFPP	PRODUCTIVITY - ALL MANUFACTURING---											
2		TAX PROPOSAL	20.653	21.191	21.975	22.476	23.659	23.870	24.922	26.077	27.195	28.149	29.235
3		BASELINE	20.653	21.190	21.878	22.606	23.524	23.879	24.983	26.172	27.310	28.306	29.346
4		DIFFERENCE	.000	.000	.097	-.131	.135	-.009	-.061	-.095	-.115	-.158	-.111
5		% DIFF	.001	.001	.442	-.578	.575	-.036	-.244	-.362	-.422	-.558	-.379
6	RXMFPP	% CHANGE											
7		TAX PROPOSAL	2.5	2.6	3.7	2.3	5.3	.9	4.4	4.6	4.3	3.5	3.9
8		BASELINE	2.5	2.6	3.2	3.3	4.1	1.5	4.6	4.8	4.3	3.6	3.7
9		DIFFERENCE	.0	.0	.5	-1.0	1.2	-.6	-.2	-.1	-.1	-.1	.2
10		% DIFF	.0	.0	14.0	-31.5	29.7	-40.8	-4.7	-2.6	-1.5	-3.9	5.1
11													
12	GNPPC	REAL PER CAPITA GNP (THOU 72 $)---											
13		TAX PROPOSAL	7.000	7.114	7.325	7.401	7.620	7.525	7.863	8.015	8.171	8.337	8.518
14		BASELINE	7.000	7.113	7.287	7.429	7.572	7.496	7.846	8.015	8.184	8.375	8.549
15		DIFFERENCE	.000	.000	.038	-.028	.049	.028	.017	-.001	-.013	-.038	-.031
16		% DIFF	.001	.002	.522	-.376	.641	.375	.218	-.007	-.159	-.456	-.367
17	GNPPC	% CHANGE											
18		TAX PROPOSAL	1.5	1.6	3.0	1.0	3.0	-1.3	4.5	1.9	1.9	2.0	2.2
19		BASELINE	1.5	1.6	2.4	2.0	1.9	-1.0	4.7	2.2	2.1	2.3	2.1
20		DIFFERENCE	.0	.0	.6	-.9	1.0	-.3	-.2	-.2	-.2	-.3	.1
21		% DIFF	.1	.0	21.8	-46.6	54.3	26.4	-3.5	-10.7	-7.4	-13.0	4.4
22													
23	VPD/NFT	REAL PER CAP DISP INC (THOU 72$)---											
24		TAX PROPOSAL	4.976	5.051	5.221	5.293	5.458	5.396	5.547	5.674	5.782	5.876	5.998
25		BASELINE	4.975	5.051	5.158	5.265	5.364	5.316	5.477	5.622	5.749	5.868	6.002
26		DIFFERENCE	.000	.000	.063	.028	.093	.080	.070	.052	.032	.008	-.004
27		% DIFF	.001	.001	1.228	.526	1.742	1.513	1.269	.930	.562	.129	-.071
28	VPD/NPT	% CHANGE											
29		TAX PROPOSAL	1.1	1.5	3.4	1.4	3.1	-1.1	2.8	2.3	1.9	1.6	2.1
30		BASELINE	1.1	1.5	2.1	2.1	1.9	-.9	3.0	2.6	2.3	2.1	2.3
31		DIFFERENCE	.0	.0	1.3	-.7	1.2	-.2	-.2	-.3	-.4	-.4	-.2
32		% DIFF	.1	.0	59.1	-34.0	65.4	24.6	-8.1	-13.0	-16.4	-21.2	-9.0
33													
34	CPUBT$	CORPORATE PROFITS BEFORE TAXES-----											
35		TAX PROPOSAL	229.2	241.6	298.9	349.6	422.3	407.7	499.6	523.2	561.1	626.0	686.7
36		BASELINE	229.2	241.6	268.2	293.9	340.3	334.4	429.9	451.1	487.5	556.2	605.4
37		DIFFERENCE	.0	.0	30.7	55.8	82.0	73.3	69.7	72.0	73.7	69.8	81.3
38		% DIFF	.0	.0	11.4	19.0	24.1	21.9	16.2	16.0	15.1	12.6	13.4
39	CPUBT$	% CHANGE											
40		TAX PROPOSAL	-2.7	5.4	23.7	17.0	20.8	-3.5	22.5	4.7	7.3	11.6	9.7
41		BASELINE	-2.7	5.4	11.0	9.6	15.8	-1.7	28.6	4.9	8.1	14.1	8.8
42		DIFFERENCE	.0	.0	12.7	7.4	5.0	-1.7	-5.0	-.2	-.8	-2.5	.8
43		% DIFF	-.1	.1	115.5	77.2	31.6	98.9	-21.1	-4.4	-9.9	-18.0	9.6
44													
45	FRMCSAAA	MOODY'S CORP. BOND RATE, AAA RATED-											
46		TAX PROPOSAL	11.39	9.65	9.66	9.62	10.29	10.67	9.70	8.82	8.63	8.32	8.47
47		BASELINE	11.39	9.65	9.64	9.64	10.26	10.63	9.63	8.69	8.50	8.22	8.42
48		DIFFERENCE	.00	.00	.02	-.02	.02	.05	.07	.13	.14	.10	.05
49		% DIFF	.00	.00	.22	-.25	.22	.45	.77	1.55	1.62	1.16	.57

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THE WHARTON LONG-TERM MODEL
TAX REFORM PROPOSAL VS. DECEMBER 1985 BASELINE

TABLE 1.00 SELECTED INDICATORS

			1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1	FRMTB3MY	MARKET YIELD, 3 MONTH TREAS BILLS--											
2		TAX PROPOSAL------------------------	7.49	6.58	7.14	7.63	8.33	9.33	6.65	6.40	6.60	6.70	6.95
3		BASELINE----------------------------	7.49	6.58	7.09	7.74	8.22	9.26	6.56	6.22	6.49	6.69	6.96
4		DIFFERENCE--------------------------	.00	.00	.05	-.11	.11	.07	.09	.18	.12	.00	-.01
5		% DIFF------------------------------	.00	.00	.75	-1.37	1.37	.81	1.40	2.87	1.80	.06	-.20
6	FM2$	MONEY SUPPLY, M2 BASIS (CURRENT $)-											
7		TAX PROPOSAL------------------------	2469	2629	2808	2977	3216	3405	3720	3947	4210	4501	4811
8		BASELINE----------------------------	2469	2629	2797	2982	3204	3388	3703	3931	4194	4495	4808
9		DIFFERENCE--------------------------	0	0	11	-5	12	17	17	16	17	6	4
10		% DIFF------------------------------	0	0	0	0	0	0	0	0	0	0	0
11	RFM2$	% CHANGE											
12		TAX PROPOSAL------------------------	8.4	6.5	6.8	6.0	8.0	5.9	9.2	6.1	6.7	6.9	6.9
13		BASELINE----------------------------	8.4	6.5	6.4	6.6	7.4	5.8	9.3	6.2	6.7	7.2	7.0
14		DIFFERENCE--------------------------	.0	.0	.4	-.6	.6	.1	.0	.0	.0	-.3	-.1
15		% DIFF------------------------------	.0	.0	6.3	-8.7	7.7	2.2	-.4	-.7	-.4	-3.7	-1.0
16													
17	NRUT	UNEMPLOYMENT RATE (%)--------------											
18		TAX PROPOSAL------------------------	7.26	7.30	6.58	6.79	6.35	7.81	6.50	6.31	6.25	6.15	6.02
19		BASELINE----------------------------	7.26	7.30	6.78	6.75	6.59	8.13	6.85	6.59	6.47	6.25	6.09
20		DIFFERENCE--------------------------	.00	.00	-.20	.03	-.25	-.32	-.35	-.28	-.23	-.10	-.08
21		% DIFF------------------------------	-.01	-.01	-3.00	.47	-3.74	-3.91	-5.10	-4.27	-3.51	-1.56	-1.27
22	YPDSAVR	SAVINGS RATE (%)-------------------											
23		TAX PROPOSAL------------------------	3.89	3.76	4.55	5.06	5.55	4.62	4.86	5.55	5.85	5.88	6.19
24		BASELINE----------------------------	3.89	3.76	4.18	4.88	5.14	4.29	4.68	5.45	5.83	5.93	6.28
25		DIFFERENCE--------------------------	.00	.00	.37	.18	.41	.33	.17	.10	.02	-.05	-.09
26		% DIFF------------------------------	.00	-.02	8.97	3.66	8.02	7.57	3.68	1.89	.37	-.79	-1.45
27													
28	GVSURPF$	SURPLUS OR DEFICIT, FEDERAL (CUR $)											
29		TAX PROPOSAL------------------------	-190.5	-172.4	-154.2	-106.6	-107.3	-108.2	-67.6	-57.2	-38.7	-18.4	2.9
30		BASELINE----------------------------	-190.5	-172.4	-142.6	-126.1	-116.7	-113.4	-78.5	-74.5	-62.9	-46.3	-38.4
31		DIFFERENCE--------------------------	.0	.0	-11.6	19.5	9.4	5.2	10.9	17.3	24.2	27.9	41.3
32		% DIFF------------------------------	.0	.0	8.1	-15.5	-8.1	-4.6	-13.9	-23.2	-38.4	-60.2	-107.6
33	GVSURPS$	SURPLUS OR DEF, STATE & LOC (CUR $)											
34		TAX PROPOSAL------------------------	50.9	46.8	62.1	63.4	77.5	60.3	81.2	87.0	88.9	95.2	104.3
35		BASELINE----------------------------	50.9	46.8	56.2	57.6	64.9	48.7	70.6	77.7	80.4	89.1	96.6
36		DIFFERENCE--------------------------	.0	.0	5.9	5.7	12.6	11.6	10.6	9.3	8.6	6.1	7.7
37		% DIFF------------------------------	.0	.0	10.6	9.9	19.4	23.8	15.0	11.9	10.7	6.8	8.0
38													
39	WBC$/VN$	COMPEN. TO EMPLOYEES TO NAT. INCOME											
40		TAX PROPOSAL------------------------	74.2	74.8	74.8	74.9	74.0	75.7	74.1	74.1	74.4	74.4	74.4
41		BASELINE----------------------------	74.2	74.8	75.0	74.5	74.2	75.6	73.8	73.8	74.1	74.2	74.3
42		DIFFERENCE--------------------------	.0	.0	-.2	.4	-.2	.1	.3	.3	.2	.3	.1
43		% DIFF------------------------------	.0	.0	-.2	.5	-.3	.1	.3	.4	.3	.4	.1
44	CPABT$/VN$	PROFITS TO NATIONAL INCOME---------											
45		TAX PROPOSAL------------------------	9.8	9.5	9.2	8.5	9.2	8.2	9.8	9.5	9.3	9.6	9.6
46		BASELINE----------------------------	9.8	9.5	9.2	9.1	9.2	8.4	10.1	9.7	9.5	9.7	9.5
47		DIFFERENCE--------------------------	.0	.0	-.1	-.6	.0	-.3	-.3	-.3	-.2	-.2	.0
48		% DIFF------------------------------	.0	.0	-.6	-6.4	.2	-3.0	-2.9	-2.8	-1.8	-1.7	.4

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THE WHARTON LONG-TERM MODEL
TAX REFORM PROPOSAL VS. DECEMBER 1985 BASELINE

TABLE 2.10 GROSS NATIONAL PRODUCT (1972 $)

		1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
	--------CONSTANT 72 DOLLARS--------											
GNP	GROSS NATIONAL PRODUCT											
	TAX PROPOSAL	1660.2	1724.7	1793.6	1830.1	1902.3	1896.1	1998.8	2054.6	2112.1	2172.7	2237.4
	BASELINE	1660.2	1724.7	1784.3	1837.0	1890.2	1889.1	1994.4	2054.8	2115.4	2182.6	2245.6
	DIFFERENCE	.0	.0	9.3	-6.9	12.1	7.1	4.4	-.1	-3.4	-10.0	-8.2
	% DIFF	.0	.0	.5	-.4	.6	.4	.2	.0	-.2	-.5	-.4
RGNP	% CHANGE											
	TAX PROPOSAL	2.5	2.6	4.0	2.0	3.9	-.3	5.4	2.8	2.8	2.9	3.0
	BASELINE	2.5	2.6	3.5	3.0	2.9	-.1	5.6	3.0	3.0	3.2	2.9
	DIFFERENCE	.0	.0	.5	-.9	1.1	-.3	-.2	-.2	-.2	-.3	.1
	% DIFF	.1	.0	15.6	-31.1	36.3	438.6	-3.0	-7.7	-5.3	-9.7	3.2
CE	PERSONAL CONSUMPTION EXPENDITURES											
	TAX PROPOSAL	1105.8	1134.5	1175.5	1198.6	1243.4	1253.9	1298.2	1330.8	1365.2	1400.6	1437.7
	BASELINE	1105.8	1134.5	1165.7	1194.3	1227.0	1239.0	1283.5	1319.2	1357.0	1397.1	1436.3
	DIFFERENCE	.0	.0	9.8	4.3	16.4	14.9	14.6	11.6	8.2	3.5	1.4
	% DIFF	.0	.0	.8	.4	1.3	1.2	1.1	.9	.6	.3	.1
CE	% CHANGE											
	TAX PROPOSAL	4.1	2.6	3.6	2.0	3.7	.8	3.5	2.5	2.6	2.6	2.6
	BASELINE	4.1	2.6	2.7	2.5	2.7	1.0	3.6	2.8	2.9	3.0	2.8
	DIFFERENCE	.0	.0	.9	-.5	1.0	-.1	-.1	-.3	-.3	-.4	-.2
	% DIFF	.0	.0	31.4	-19.8	36.4	-13.3	-1.9	-9.6	-9.7	-12.3	-5.6
CED	DURABLE GOODS											
	TAX PROPOSAL	191.8	195.2	207.0	207.8	219.0	213.4	229.1	233.4	240.0	246.6	253.8
	BASELINE	191.8	195.2	202.0	207.0	212.2	208.5	224.9	231.0	238.8	247.4	254.8
	DIFFERENCE	.0	.0	5.1	.8	6.8	4.8	4.3	2.3	1.2	-.8	-.9
	% DIFF	.0	.0	2.5	.4	3.2	2.3	1.9	1.0	.5	-.3	-.4
CED	% CHANGE											
	TAX PROPOSAL	7.7	1.8	6.1	.3	5.4	-2.6	7.4	1.8	2.8	2.8	2.9
	BASELINE	7.7	1.8	3.5	2.5	2.5	-1.7	7.8	2.7	3.4	3.6	3.0
	DIFFERENCE	.0	.0	2.6	-2.1	2.9	-.8	-.5	-.9	-.5	-.8	.0
	% DIFF	.1	.1	73.9	-86.0	113.7	48.3	-5.8	-32.4	-16.0	-23.1	-1.6
CEN	NONDURABLE GOODS											
	TAX PROPOSAL	404.1	416.0	428.5	434.6	447.9	450.2	460.7	470.4	478.2	486.7	496.4
	BASELINE	404.1	416.0	425.4	433.2	442.6	445.5	456.2	466.7	475.8	485.8	496.3
	DIFFERENCE	.0	.0	3.1	1.4	5.3	4.7	4.5	3.7	2.4	.9	.1
	% DIFF	.0	.0	.7	.3	1.2	1.0	1.0	.8	.5	.2	.0
CEN	% CHANGE											
	TAX PROPOSAL	2.7	2.9	3.0	1.4	3.0	.5	2.3	2.1	1.7	1.8	2.0
	BASELINE	2.7	2.9	2.3	1.8	2.2	.7	2.4	2.3	1.9	2.1	2.2
	DIFFERENCE	.0	.0	.7	-.4	.9	-.1	-.1	-.2	-.3	-.3	-.2
	% DIFF	.0	.0	32.8	-22.9	41.4	-21.9	-2.4	-8.7	-14.5	-15.7	-8.1

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THE WHARTON LONG-TERM MODEL
TAX REFORM PROPOSAL VS. DECEMBER 1985 BASELINE

TABLE 2.10 GROSS NATIONAL PRODUCT (1972 $)

			1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1	CES	SERVICES											
2		TAX PROPOSAL	510.0	523.4	539.9	556.3	576.5	590.4	608.3	627.0	647.0	667.3	687.5
3		BASELINE	510.0	523.4	538.3	554.1	572.2	584.9	602.5	621.5	642.4	663.9	685.3
4		DIFFERENCE	.0	.0	1.6	2.2	4.3	5.4	5.9	5.5	4.6	3.4	2.2
5		% DIFF	.0	.0	.3	.4	.8	.9	1.0	.9	.7	.5	.3
6	CES	% CHANGE											
7		TAX PROPOSAL	3.9	2.6	3.2	3.0	3.6	2.4	3.0	3.1	3.2	3.1	3.0
8		BASELINE	3.9	2.6	2.8	2.9	3.3	2.2	3.0	3.2	3.4	3.4	3.2
9		DIFFERENCE	.0	.0	.3	.1	.4	.2	.0	-.1	-.2	-.2	-.2
10		% DIFF	.0	.0	11.0	3.1	11.3	8.0	1.8	-2.6	-5.3	-6.5	-5.8
11													
12	IBT	GROSS PRIVATE DOMESTIC INVESTMENT											
13		TAX PROPOSAL	289.8	300.0	321.4	318.2	336.2	300.7	354.7	366.8	378.2	391.1	408.0
14		BASELINE	289.8	300.0	319.4	330.4	338.2	307.9	364.4	378.7	390.6	406.6	419.9
15		DIFFERENCE	.0	.0	1.9	-12.2	-2.0	-7.2	-9.7	-12.0	-12.3	-15.5	-11.9
16		% DIFF	.0	.0	.6	-3.7	-.6	-2.3	-2.7	-3.2	-3.2	-3.8	-2.8
17	IBT	% CHANGE											
18		TAX PROPOSAL	.0	3.5	7.1	-1.0	5.7	-10.6	18.0	3.4	3.1	3.4	4.3
19		BASELINE	.0	3.5	6.5	3.4	2.4	-9.0	18.4	3.9	3.1	4.1	3.3
20		DIFFERENCE	.0	.0	.6	-4.4	3.3	-1.6	-.4	-.5	.0	-.7	1.0
21		% DIFF	-9.0	.0	9.8	-128.9	140.4	17.9	-2.1	-13.6	.2	-17.0	31.9
22													
23	IBF	FIXED INVESTMENT											
24		TAX PROPOSAL	279.3	289.7	306.7	305.8	321.3	301.8	337.1	347.7	359.7	371.8	389.0
25		BASELINE	279.3	289.7	306.0	317.0	324.5	309.6	346.2	359.1	370.7	385.8	400.0
26		DIFFERENCE	.0	.0	.7	-11.2	-3.2	-7.8	-9.1	-11.4	-11.0	-14.0	-11.1
27		% DIFF	.0	.0	.2	-3.5	-1.0	-2.5	-2.6	-3.2	-3.0	-3.6	-2.8
28	IBF	% CHANGE											
29		TAX PROPOSAL	5.4	3.7	5.8	-.3	5.1	-6.1	11.7	3.2	3.4	3.4	4.6
30		BASELINE	5.4	3.7	5.6	3.6	2.4	-4.6	11.8	3.7	3.2	4.1	3.7
31		DIFFERENCE	.0	.0	.2	-3.9	2.7	-1.5	-.1	-.6	.2	[illegible]	.9
32		% DIFF	.0	.0	4.2	-107.4	113.4	32.2	-1.0	-15.5	6.9	-17.5	24.8
33													
34	IBFN	NONRESIDENTIAL											
35		TAX PROPOSAL	217.7	225.8	238.9	245.5	255.3	247.9	267.3	282.2	294.3	306.1	318.0
36		BASELINE	217.7	225.8	239.0	249.5	259.2	253.9	274.2	290.1	303.1	316.3	328.5
37		DIFFERENCE	.0	.0	-.1	-4.0	-3.8	-6.0	-6.9	-7.9	-8.8	-10.1	-10.5
38		% DIFF	.0	.0	-.1	-1.6	-1.5	-2.4	-2.5	-2.7	-2.9	-3.2	-3.2
39	IBFN	% CHANGE											
40		TAX PROPOSAL	6.3	3.7	5.8	2.8	4.0	-2.9	7.9	5.6	4.3	4.0	3.9
41		BASELINE	6.3	3.7	5.9	4.4	3.9	-2.0	8.0	5.8	4.5	4.3	3.9
42		DIFFERENCE	.0	.0	-.1	-1.6	.1	-.9	-.1	-.2	-.2	-.3	.0
43		% DIFF	.0	.0	-1.0	-37.2	3.7	44.2	-1.8	-4.2	-4.4	-7.3	.5
44													
45	IBFR	RESIDENTIAL STRUCTURES											
46		TAX PROPOSAL	61.6	64.0	67.8	60.4	66.0	53.9	69.7	65.5	65.4	65.6	70.9
47		BASELINE	61.6	64.0	66.9	67.5	65.4	55.7	72.0	69.0	67.6	69.5	71.6
48		DIFFERENCE	.0	.0	.8	-7.1	.6	-1.8	-2.2	-3.5	-2.2	-3.8	-.6
49		% DIFF	.0	.0	1.2	-10.6	1.0	-3.2	-3.1	-5.0	-3.2	-5.5	-.9

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THE WHARTON LONG-TERM MODEL
TAX REFORM PROPOSAL VS. DECEMBER 1985 BASELINE

TABLE 2.10 GROSS NATIONAL PRODUCT (1972 $)

			1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1	IBFR	% CHANGE											
2		TAX PROPOSAL	2.3	3.9	5.9	-10.9	9.3	-18.3	29.4	-6.1	-.2	.4	8.1
3		BASELINE	2.3	3.9	4.7	.8	-3.2	-14.8	29.2	-4.1	-2.1	2.8	3.0
4		DIFFERENCE	.0	.0	1.3	-11.7	12.5	-3.5	.2	-1.9	1.9	-2.5	5.1
5		% DIFF	.4	-.1	27.1	******	-393.7	23.7	.6	46.6	-92.3	-87.7	167.8
6													
7	IBIT	CHANGE IN BUSINESS INVENTORIES											
8		TAX PROPOSAL	10.5	10.2	14.7	12.3	14.9	-1.1	17.6	19.0	18.5	19.3	19.1
9		BASELINE	10.5	10.2	13.5	13.4	13.7	-1.7	18.2	19.6	19.8	20.8	19.9
10		DIFFERENCE	.0	.0	1.2	-1.1	1.2	.6	-.6	-.6	-1.3	-1.5	-.8
11		% DIFF	.0	.0	9.1	-7.9	9.0	-35.4	-3.3	-3.0	-6.8	-7.2	-4.0
12													
13	TBB	NET EXPORTS OF GOODS AND SERVICES											
14		TAX PROPOSAL	-34.7	-34.7	-30.2	-20.9	-19.8	-9.6	-14.5	-12.5	-10.0	-7.1	-5.7
15		BASELINE	-34.7	-34.7	-27.8	-21.9	-17.5	-9.0	-13.9	-12.7	-10.8	-9.1	-8.0
16		DIFFERENCE	.0	.0	-2.4	1.0	-2.3	-.7	-.6	.2	.7	2.0	2.2
17		% DIFF	.0	.0	8.7	-4.5	13.1	7.3	4.2	-1.9	-6.9	-22.2	-26.1
18													
19	TEB	EXPORTS											
20		TAX PROPOSAL	139.7	145.8	157.0	166.4	175.0	184.4	192.4	203.2	214.1	225.6	236.8
21		BASELINE	139.7	145.8	157.0	166.2	174.9	184.2	192.3	203.3	214.4	226.1	237.3
22		DIFFERENCE	.0	.0	.0	.2	.1	.3	.0	-.1	-.3	-.5	-.6
23		% DIFF	.0	.0	.0	.1	.0	.1	.0	.0	-.2	-.2	-.2
24	TEB	% CHANGE											
25		TAX PROPOSAL	-4.3	4.4	7.7	6.0	5.2	5.4	4.3	5.6	5.4	5.4	5.0
26		BASELINE	-4.3	4.4	7.7	5.9	5.2	5.3	4.4	5.7	5.5	5.4	5.0
27		DIFFERENCE	.0	.0	.0	.1	-.1	.1	-.1	-.1	-.1	-.1	.0
28		% DIFF	.0	.0	.0	2.1	-1.4	2.0	-3.3	-.9	-2.2	-1.1	-.6
29													
30	TMB	IMPORTS											
31		TAX PROPOSAL	174.4	180.4	187.2	187.3	194.8	194.0	206.8	215.7	224.1	232.7	242.5
32		BASELINE	174.4	180.4	184.8	188.1	192.5	193.1	206.2	216.0	225.2	235.2	245.3
33		DIFFERENCE	.0	.0	2.4	-.8	2.4	.9	.6	-.3	-1.1	-2.5	-2.8
34		% DIFF	.0	.0	1.3	-.4	1.2	.5	.3	-.2	-.5	-1.1	-1.2
35	TMB	% CHANGE											
36		TAX PROPOSAL	8.2	3.5	3.8	.1	4.0	-.4	6.6	4.3	3.9	3.8	4.2
37		BASELINE	8.2	3.5	2.4	1.8	2.3	.3	6.8	4.7	4.3	4.4	4.3
38		DIFFERENCE	.0	.0	1.3	-1.7	1.7	-.6	-.2	-.5	-.3	-.6	-.1
39		% DIFF	.0	.0	55.0	-96.7	74.1	-216.7	-2.9	-9.8	-8.1	-13.8	-2.1
40													
41	GVPT	GOV'T PURCH OF GOODS AND SERVICES											
42		TAX PROPOSAL	319.3	324.8	326.9	334.2	342.5	351.2	360.4	369.6	378.7	388.1	397.4
43		BASELINE	319.3	324.8	326.9	334.2	342.5	351.2	360.4	369.6	378.7	388.1	397.4
44		DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
45		% DIFF	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
46	GVPT	% CHANGE											
47		TAX PROPOSAL	5.7	1.7	.6	2.2	2.5	2.5	2.6	2.5	2.5	2.5	2.4
48		BASELINE	5.7	1.7	.6	2.2	2.5	2.5	2.6	2.5	2.5	2.5	2.4
49		DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
50		% DIFF	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0

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                              THE WHARTON LONG-TERM MODEL
                        TAX REFORM PROPOSAL VS. DECEMBER 1985 BASELINE

                         TABLE 2.10  GROSS NATIONAL PRODUCT (1972 $)
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|       |                                 |  1985   1986   1987   1988   1989   1990   1991   1992   1993   1994   1995|
-------------------------------------------------------------------------------------------------------------------
  1|       |                                 |                                                                             |
  2|GVPF   |  FEDERAL------------------------|                                                                             |
  3|       |TAX PROPOSAL---------------------|  134.7  135.3  134.9  138.1  141.9  145.9  150.3  154.6  158.9  163.2  167.6|
  4|       |BASELINE-------------------------|  134.7  135.3  134.9  138.1  141.9  145.9  150.3  154.6  158.9  163.2  167.6|
  5|       |DIFFERENCE-----------------------|     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0|
  6|       |% DIFF---------------------------|     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0|
  7|GVPF   |                         % CHANGE|                                                                             |
  8|       |TAX PROPOSAL---------------------|   10.0     .5    -.3    2.3    2.7    2.8    3.0    2.8    2.7    2.7    2.7|
  9|       |BASELINE-------------------------|   10.0     .5    -.3    2.3    2.7    2.8    3.0    2.8    2.7    2.7    2.7|
 10|       |DIFFERENCE-----------------------|     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0|
 11|       |% DIFF---------------------------|     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0|
 12|       |                                 |                                                                             |
 13|GVPS   |  STATE AND LOCAL----------------|                                                                             |
 14|       |TAX PROPOSAL---------------------|  184.   189.5  192.0  196.1  200.7  205.4  210.1  214.9  219.8  224.8  229.8|
 15|       |BASELINE-------------------------|  184.6  189.5  192.0  196.1  200.7  205.4  210.1  214.9  219.8  224.8  229.8|
 16|       |DIFFERENCE-----------------------|     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0|
 17|       |% DIFF---------------------------|     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0|
 18|GVPS   |                         % CHANGE|                                                                             |
 19|       |TAX PROPOSAL---------------------|    2.8    2.7    1.3    2.1    2.3    2.3    2.3    2.3    2.3    2.3    2.2|
 20|       |BASELINE-------------------------|    2.8    2.7    1.3    2.1    2.3    2.3    2.3    2.3    2.3    2.3    2.2|
 21|       |DIFFERENCE-----------------------|     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0|
 22|       |% DIFF---------------------------|     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0     .0|
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The **Chairman**. We follow in this committee a first-come, first-question rule. I am going to read the list as I have it, and you can correct me if I am wrong.

It goes as follows: Senators Long, Moynihan, Packwood, Heinz, Danforth, Mitchell, Grassley, Bentsen, Baucus, Chafee, Symms, and Bradley.

Senator Long.

Senator **Long**. If I understood you correctly, Dr. Chimerine, you said that in the short run, this bill would cause a reduction in production and business activities.

Dr. **Chimerine**. That is right, Senator.

Senator **Long**. Dr. Brinner, is that your conclusion also?

Dr. **Brinner**. In the short run, we find that the stimulus from the consumer tax cut would largely offset the restraint from the business tax increase; but I must say that the risks are not equally balanced.

Some alternative models that we have, for example, of nonresidential construction, looking at office buildings, hotels, et cetera, specifically suggest that this baseline simulation might understate by a factor of five the short-term losses in nonresidential construction.

If we factored those in, then on average for the first 5 years, our real GNP loss would be eight-tenths of 1 percent.

So, that gives you some estimate of the sensitivity here.

Senator **Long**. I am concerned about what happens in some industries.

For example, prior to the Arab boycott, there was a 17-year period where this Government saw fit to do nothing whatever about the decline in energy production. So, when the Arabs hit us with that boycott, we were in no position to handle the problem.

When the second boycott came a few years later, we were in even worse shape because nothing had been done to stimulate domestic energy production.

My guess is that we are in even worse shape now. Would this bill do anything to help or hurt energy production?

Dr. **Chimerine**. Yes.

Senator **Long**. What?

Dr. **Chimerine**. Do you want me to be more specific?

Senator **Long**. Yes, sir. I would like you to be more specific.

Dr. **Chimerine**. I think, Senator, it would probably have a small negative effect on domestic energy production because some of the tax benefits that go to that sector are scaled back, as well as the general incentives for investment.

I think that would probably be true both in the short term and the long term.

In the short term, if I can just go back to your first question for a second, I tend to agree with my colleagues that there will be an increase in consumer spending.

And I think that is why, after the first 6 to 12 months, the economy will then catch back up to where it would have been because consumer spending will generate a somewhat faster growth from the initial depressed conditions.

But when you shock the system as much as this bill will in the first year, given the large declines we are going to get in investment and construction, particularly—for example, we talked about how vulnerable the economy is—we have got all these leverage buy-outs and a tremendous increase in corporate debt.

Most of those companies are not planning on reduced cash-flow from tax reform for the next several years. They are going to have a very difficult time servicing that debt under these conditions, including some people in the energy industry.

As a result, you are going to get sizable declines in investment. The kicking in of consumption will help alleviate the situation 6 to 12 months later; but in the very near term, the very first 6 to 12 months, I think both in the energy industry and throughout the capital goods producing sector and the construction industries, we will have some very, very negative effects.

Senator LONG. Beginning with the high point of drilling that occurred after President Reagan came into office, can you tell me what percent of drilling rigs have been taken out of drilling?

Dr. CHIMERINE. I don't have the number right in front of me, but it is a very large number, Senator.

Senator LONG. I would guess about 60 percent.

Dr. CHIMERINE. I would guess 50, but I will take your number.

Senator LONG. So, if we are concerned about energy independence, we are moving in just the opposite direction; and this bill would make it worse?

Dr. CHIMERINE. It would make it worse.

Senator LONG. Thank you.

The Chairman. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I would first like to thank our panelists for a very clear and succinct set of views.

Over our weekend in West Virginia, we occasionally talked about this issue of the cost of capital.

Dr. Schink, you addressed this most explicitly. I think you suggested that there would be an average increase in the cost of capital of 12.5 percent, about a one-eighth increase.

Dr. Chimerine and Dr. Brinner, do you share the judgment that there is a clear and pronounced increase in the cost of capital?

Dr. CHIMERINE. Absolutely.

Senator MOYNIHAN. Dr. Brinner.

Dr. BRINNER. Our estimate, as I said, was that the average after-tax cost of a combination of debt and equity would go up from 8.5 to 9 percent; but then when you also factor in the change in the depreciation allowances and the loss of the investment tax credit, the after-tax cost of buying and using equipment would be up by 17 to 20 percent, of public utility structures by 15 to 20 percent.

So, it is double digit, clearly.

Senator MOYNIHAN. To your knowledge, has there been such an increase in capital costs as a result of a change in the Tax Code? I don't think there has been.

Dr. CHIMERINE. No. I think, Senator, over the last 25 or 30 years, most of the changes have been in the other direction.

Senator MOYNIHAN. That is something, Mr. Chairman, worth nothing.

I will ask another question. This is an issue which we have not dealt with in this committee.

On the question of the deduction for State and local taxes, which Dr. Brinner you raised, I think of that article by Thibou in the Journal of Political Economy on the theory of local expenditures. I'm sure you are all familiar with it.

If you think of the costs of education in terms of property tax levied by school districts, an economist would agree that to eliminate the deductibility from some other tax system of that local property tax is to increase the cost of that tax.

Do you agree that the real cost of school taxes goes up if you eliminate deductibility?

Dr. **Brinner**. The cost of school taxes goes up, but you would also have to agree——

Senator **Moynihan**. Does everybody agree that the cost of school taxes goes up?

Dr. **Chimerine**. Yes.

Dr. **Brinner**. Yes.

Dr. **Schink**. Yes.

Senator **Moynihan**. All right. I am sorry, Dr. Brinner.

Dr. **Brinner**. But the public finance economists would also note that this is a clear case of a service that is being purchased, and so the deductibility is a way of the Federal Government subsidizing that, just as you——

Senator **Moynihan**. Some might call it subsidy, and some might call it federalism; but we won't get into that argument.

I ask you this: Is it also not generally the case in the literature, as they say, that an increase in cost of a local tax that is associated with elasticity, and in the case of school taxes, the elasticity is going to be about 0.5, and you have predicted that a 40-percent increase in school taxes—which is what CRS says would happen here—could at least, from the literature, lead to a 20-percent decline in school expenditures?

Dr. **Brinner**. I think that is wholly too many other things equal. I don't think that there are any circumstances that you would have State and local governments responding to an end of deductibility by cutting their expenditures by 20 percent.

I think they would find other ways to finance it.

Senator **Moynihan**. They would raise their taxes.

Dr. **Brinner**. Yes; I think so.

Senator **Moynihan**. They would raise their taxes. They would either raise their taxes or cut their outlays.

Dr. **Brinner**. They don't have to raise their taxes just because the Federal Government ceases to allow their citizens to deduct them. They simply have to resist the pressure from their citizens to cut their taxes because the after-tax Federal——

Senator **Moynihan**. Dr. Schink, you seem to have a slight diversion here.

Dr. **Schink**. The pressure on the State and local governments is to hold down or cut taxes, the same as everywhere else. And I think the resistance to tax increases, for whatever reason the money was needed, would be still very strong.

And I am not as optimistic as Dr. Brinner about the willingness of State governments to take on the voters who have expressed no desire for increase in taxes.

Senator MOYNIHAN. So, it would be not unreasonable to—among the various scenarios would be a reduction in education expenditures?

Dr. SCHINK. I think there would be some. Yes.

Senator MOYNIHAN. Thank you very much; but I do want to go back to another point.

There is a general agreement in our group here that there is a double-digit increase in the cost of capital associated with this legislation?

Dr. SCHINK. Yes.

Senator MOYNIHAN. And we have not tried that experiment?

Dr. BRINNER. Only through higher cost of financing brought about by high interest rates.

You could probably find a comparable increase during the last several years brought about by those high interest rates.

Senator MOYNIHAN. A fair point, and I will return to it. Thank you.

The CHAIRMAN. Dr. Chimerine, on page 23 and page 24 of your statement, you say the United States does not appear to be a saving-oriented society, so that changes in after-tax rates of return do not have significant effects on saving patterns in either direction.

Can you elaborate what you mean by that?

Dr. CHIMERINE. Yes. I think Senator Mitchell referred to this earlier.

We cut marginal tax rates dramatically in 1981. We implemented a program which included—a savings program—IRA's, KEOGH's, 401(K)'s.

We have had the highest real interest rates, probably in our history. We deregulated financial institutions, which gives savers more alternatives to earn higher yields.

Yet during this period the personal saving rate has dropped sharply instead of going in the other direction.

Now, clearly, there are some demographic factors and other forces that are partly responsible for that, but all I am suggesting is that those who argue that reductions in marginal tax rates and other savings incentives do stimulate savings, I think, cannot support that effectively or conclusively by looking at the evidence, particularly the evidence of the last 4 or 5 years, but even on a longer term basis.

The CHAIRMAN. So, if we are going to try to encourage investment, we might as well forgo at least trying to somehow artificially encourage personal savings. It just doesn't work.

Dr. CHIMERINE. That is correct.

The CHAIRMAN. All right.

Now, second, how did we happen to do so well in terms of productivity, expansion, investment in the 1950's and 1960's in this country? We still have a relatively low savings rate in comparison to other societies.

We had reasonably higher corporate profits taxes. We had no investment tax credit until the Kennedy years.

And yet, things moved along rather well. Why is that?

Dr. **Chimerine**. The issue of productivity, Senator, is extremely complicated. I think there are four or five factors that probably have combined to explain that.

The **Chairman**. We seem to find the capital to invest somehow. Why was that?

Dr. **Chimerine**. You mean in recent years?

The **Chairman**. No; I meant in the 1950's and 1960's. When businesses had to expand, they found available capital.

Still, even then, we had a relatively low savings rate and we didn't have the corporate incentives to invest that we have now.

Dr. **Chimerine**. I don't think that is entirely true, Mr. Chairman. We implemented corporate investment incentives in the early 1960's through accelerated depreciation and the investment tax credit.

All of our studies indicate they had very stimulative impacts on investment. Much of the funding for investment spending in the 1950's and 1960's came from the same place it always does: household savings and corporate cash-flow.

My argument, for the next 10 or 15 years, is if you don't get an increase in personal savings, and you are squeezing corporate cash-flow——

The **Chairman**. Is household savings the same as personal savings?

Dr. **Chimerine**. Yes.

The **Chairman**. All right.

Dr. **Chimerine**. On a net basis, you will reduce the available savings flow to finance investment in the United States.

There is evidence that it has already begun because, over the last 3 or 4 years, much of it has come from overseas. Without that, there would already have been a dramatic squeezing in the amount of cash-flow or funds available to finance new investment in the United States.

If we start losing that money coming from overseas, and at the same time reduce corporate cash-flow in the future, I think we could have a very, very serious squeeze on business investment; and fundamentally, that is what we are all saying.

The **Chairman**. Dr. Brinner.

Dr. **Brinner**. Yes. This is one of my pet areas, productivity analysis; and what we concluded was the source of strong productivity growth, particularly in the 1960's, was the expansion of R&D activities, expanding our knowledge and increasing the productivity not only of capital but also of labor, and the very strong growth in business fixed investment and the capital stock associated with that.

The slowdown beginning in the 1970's and continuing to some extent to date, we trace to the diversion of funds to pollution abatement expenditures—a valuable national activity—but it doesn't increase the measured output per hour of employees and to the problems of investment in a high interest rate environment.

So, I don't find much of a surprise after poring through the R&D and capital formation data, why the 1960's were a very good period and the late 1970's and early 1980's not so good.

The **Chairman**. Dr. Schink.

Dr. **Schink.** The situation in the 1950's, I think, was in many ways very different. You know, we were almost without competition internationally.

The European countries and Japan were still trying to recover. We had markets to ourselves and were growing very rapidly.

We had the benefit of an awful lot of technology that was developed during the Second World War to implement; and these are situations that just don't prevail today.

We have very strong international competition and we don't have any kind of lock on technological development. The Europeans and the Japanese are very much with us on that.

The **Chairman.** Let me ask a last question, starting with Dr. Chimerine.

You indicate that this tax cut is really not going to get individuals to increase savings; they will just spend it, but they won't save it.

Dr. **Chimerine.** No; there will be some increase in savings, but the overall saving rate—the percentage of their income which they save—probably won't go up substantially; but the level of savings will rise because they will have more after-tax income.

All I am suggesting is that that by itself will not be sufficient to fund a dramatic increase in investment that offset the negative effect of reduced corporate cash-flow.

The **Chairman.** Senator Heinz.

Senator **Heinz.** Mr. Chairman, I shouldn't do this, but I would like to have you, without comment, think in terms of why the 1950's and 1960's also might have been weighted in our favor. Take into account the relatively lower plural rates of return that business required operating in a much more stable economic climate as perhaps being the most important reason, not unrelated to all the things you have said, but nonetheless, a critical reason for investment moving ahead.

The inventions of some financial analysis technique and its applicability, discounted cash-flows, and a variety of techniques introduced in those years that nobody else had. Also a product of our minds to go along with our technology.

You are all in favor of the notion of tax reform. You all said that both the House bill and the President's bill move directionally in the right direction.

You have also said, don't go that far; and some of you have made suggestions as to how we could mitigate the worst effects of both legislative proposals.

I would like to pin you down a little bit more.

Now, Dr. Chimerine, you emphasized that in the short run there would be some very bad effects because of the rapidity of change.

Your colleagues did not so emphasize that. So, Dr. Brinner, you see a risk to the rapidity of change here?

Dr. **Brinner.** Very definitely. As I said, when you analyze investment as it might be impacted by the minimum tax provisions and some of the others on the personal side—not just the corporate side—that is when I particularly find a large risk.

Those, I suppose, I am more willing to live with because those are the ones that generate the greatest sense of unfairness.

Senator **Heinz**. I have a series of questions and limited time. Dr. Schink, do you share Dr. Chimerine's concern about the rapidity of change?

Dr. **Schink**. Yes; we see many downside risks in the short term, and we see a real possibility of the kind of scenario that Dr. Chimerine described.

Senator **Heinz**. Now, one of those risks, I gather, is a shooting up in the price of housing, something that we are all told is already much more costly than it has ever been, that housing, as Americans have come to know it, owning your own home or condo, is out of the reach of many who 10 years ago would have found it possible to own their own housing.

Is either of these bills going to make that situation worse in the short run? Dr. Chimerine.

Dr. **Chimerine**. Yes; although quite frankly, Senator, I think in the short run the big effect will be on apartment and condominium construction. It will be on multifamily construction rather than on single-family, because of the lack of syndication and all the tax shelter activity that supports that will be curtailed dramatically.

Senator **Heinz**. Now, I think Dr. Brinner disagrees with you, but maybe I am wrong.

Dr. **Brinner**. It was the nonresidential construction that I said would be heavily penalized by some of the provisions.

I calculate that the average mortgage payment after tax would slightly decline under the House proposed bill. So, I don't find residential construction threatened by this proposal.

Senator **Heinz**. Dr. Schink, what do you find?

Dr. **Schink**. We find that housing costs would be up significantly.

Senator **Heinz**. Housing costs would be up significantly? There is a disagreement between you and Dr. Brinner.

Dr. **Schink**. The after-tax cost of home ownership is up, and I agree strongly with Dr. Chimerine that the removal of incentives to build multifamily housing would in fact drive rental rates up very sharply over the near term.

Senator **Heinz**. Now, you have all said that we are going to suffer both at home and abroad because we are going to be less competitive relative to our international competitors. Is that correct? There is no disagreement with that statement.

Second, correct me if I am wrong, two of you have said that our long run growth is going to suffer. Dr. Brinner, you said productivity—labor productivity—would be down on the average of 1½ percent per year.

Dr. **Brinner**. Not per year. It would accumulate to 1½ percent over a decade.

Senator **Heinz**. It would accumulate to 1½ percent over the decade.

Dr. Schink, you said that we would have a lower standard of living. I think you put a price tag of $600 per family on that, or something like that.

Dr. **Schink**. That was not me.

Senator **Heinz**. Excuse me. It is hard to keep track of all your testimony.

Dr. **Schink**. OK.

Senator **Heinz**. Dr. Chimerine, you said you thought we might catch up after 5 years. Why are you so optimistic compared to the people on either side of you? [Laughter.]

Dr. **Chimerine**. Well, primarily because I am hopeful, Senator, that there will be some efficiency effects, that the decline in the volume of investments and the quantity of investments will be moving away from the most inefficient kinds of investment; and as a result, average productivity wouldn't be hurt too badly.

But I tend to agree with them directionally, that if I am wrong, that it will be worse. That is, I find no evidence to support the view that the economy will be better on a long-term basis.

I am hopeful it will be about the same, but it could be somewhat worse.

Senator **Heinz**. One last yes-or-no question.

You all indicated, yes or no, that this bill is unlikely to be revenue neutral. It is likely to be a revenue loser. Yes or no? Dr. Chimerine.

Dr. **Chimerine**. Yes.

Senator **Heinz**. Dr. Brinner.

Dr. **Brinner**. No; I think that it, in fact, might raise a little revenue.

Senator **Heinz**. Dr. Schink.

Dr. **Schink**. I agree with Dr. Brinner. It will raise a little revenue.

Senator **Heinz**. All right. Thank you.

The **Chairman**. Senator Danforth.

Senator **Danforth**. Mr. Chairman, I notice that Senator Long not only doesn't want to be the cochairman of the committee; he doesn't want to be seen with the chairman. [Laughter.]

Senator **Long**. You should be chairing right now, Senator Danforth. Move over. [Laughter.]

Senator **Danforth**. Gentlemen, all of you, I think, referred to the question of international competitiveness. Today the trade figures are going to be released for 1985.

Most people think that they will show—they may have been released by now, for all I know—but most people believe that they will show around a $50 billion trade deficit that we are running with the rest of the world.

That number has been growing very rapidly in the last few years.

Could you spell out why you believe the House bill and the administration bill will have negative effects on our international competitiveness? And could you attempt to quantify what that effect would be?

Dr. Schink, do you want to start?

Dr. **Schink**. The main reason I think it will reduce our competitiveness is that the countries we compete with offer incentives to investment. In other words, they have investment tax credits. They have accelerated depreciation.

That is, in some sense I think, even more favorable to investment of certain kinds than we are.

The Japanese and Germans are very good at targeting their capital incentives to encourage specific investment behavior.

We are moving away from that and, in essence, discouraging investment and therefore reducing productivity.

It is hard to sort all the effects out, but that effect is a worsening of the trade balance.

I don't have the numbers right in front of me so I——

Senator DANFORTH. I am sorry. I didn't hear you.

Dr. SCHINK. The net effect of being able to compete effectively in third markets and to have more competition in domestic markets, where foreign countries are in fact offering incentives to invest and therefore reducing their labor costs by offering these incentives, we will be less able to compete, both in terms of keeping a share of our own market and competing in Third World markets where we are competing with Germany and Japan for business.

Senator DANFORTH. Can you quantify the effect on the trade deficit?

Dr. SCHINK. I don't have the numbers in front of me, but you know, I think it is $10 billion or something like that. I would have to look it up; I don't have the numbers with me.

Senator DANFORTH. Do you think it would be about $10 billion per year?

Dr. SCHINK. Something like that.

Senator DANFORTH. An increase in the trade deficit?

Dr. SCHINK. Something like that; but I will have to check.

Senator DANFORTH. If you have those figures, could you submit them to the committee?

Dr. SCHINK. I will.

Senator DANFORTH. Thank you. Dr. Chimerine.

Dr. CHIMERINE. Senator, it comes down to the cost of capital; and while I don't want to suggest that the difference in the cost of capital in the United States with Japan and other countries is the main reason we have $150 billion trade deficit, it is a factor.

This bill would make it—both the administration and the House bills—worse. Again, it is not something you are going to see develop overnight. It is not going to double our trade deficit.

Our numbers are between $5 and $10 billion a year worse on a long-term basis as well; but what seems to me to be significant is just going in the wrong direction.

This is the time we ought to be doing things that will try to improve our competitiveness in world markets, and this probably goes in the wrong direction, primarily by increasing the cost of capital in the United States.

Senator DANFORTH. Dr. Brinner.

Dr. BRINNER. Let's look at the different pieces of our cost structure. On table 4 of my testimony, I indicate that on average, after this program has had a chance to hurt our capital structure, in the second 5 years of the program output per hour would be 1.1 percent lower, even giving credit for efficiency gains, and wages would be 1 percent higher.

So, unit labor costs, 2 percent higher. I have indicated the cost of using capital would be overall, combining structure and equipment, about 15 percent higher.

That means our total costs would be on the order of 5 to 6 percent higher.

We might avoid a major deterioration of the trade balance by having our exchange rate adjust to be 5 or 6 percent weaker, but that means our standard of living relative to the rest of the world is 5 or 6 percent lower.

So, you might never see it in the trade account on the deficit, but that would be only if we didn't reduce our exchange rate by 5 or 6 percent.

Senator **Danforth**. Right, but does the exchange rate have anything to do with the tax bill if it is revenue neutral?

Dr. **Brinner**. Yes. As I just said, if we have a revenue neutral tax bill constructed this way, the total cost of producing manufactured goods in this country would be increased by about 5 or 6 percent.

In order for our trade to balance with our current account, we would need to have the exchange rate moved down by this 5 to 6 percent.

So, there would be that pressure to reduce our standard of living relative to the rest of the world created by higher costs.

Senator **Danforth**. Thank you.

The **Chairman**. Senator Mitchell.

Senator **Mitchell**. Thank you, Mr. Chairman.

Gentlemen, the previous questioner, holding a particular point of view, elicited from you statements regarding the extent to which our long-term growth will suffer.

I hold a different point of view; and I read your testimony and reach a different conclusion.

Dr. Chimerine, on page 28 of your statement, when you are reaching a concluding point, your statement reads, and I quote:

> When we add the pluses and minuses, our general conclusion is that overall economic conditions will not be significantly changed on a long-term basis if either tax reform proposal were enacted.

Do you stand by that statement?

Dr. **Chimerine**. Yes; and I said earlier, Senator, that our conclusion is that 15 years from now, if we pass the tax reform bill—either one—the economy overall, not the industry mix now, but the economy overall—the GNP, for example—probably won't be much different.

And if I am wrong, I am more likely to be wrong on the downside. It might be somewhat weaker. Yes.

Senator **Mitchell**. And in your statement, you make a number of qualifications as to the actual long-term effects; and more importantly, on page 13 of your statement, you note that structural changes in tax reform are really not capable of being analyzed precisely in econometric models.

Isn't that correct?

Dr. **Chimerine**. I think it is very difficult. Yes.

Senator **Mitchell**. Right. Now, Dr. Brinner, in your testimony you attach a series of tables, and I am looking right at this moment at table 4 in your testimony in which you predict the effect of the House-passed tax bill on real GNP.

And in the long term, you estimate that passage of that bill would cause the gross national product to be three-tenths of 1 percent below what it would otherwise be under current law.

Given the limitations of making such predictions as Dr. Chimerine has just noted, do you not agree that a three-tenths of 1 percent margin, predicting events in the next decade, is quite small, well within the margin of error, and some might even argue statistically irrelevant?

Dr. **Brinner**. I would agree that the real GNP result here—in fact, my testimony so notes—is insignificantly different from zero, but I also emphasized that this is a misleading number, that it is only achieved because we start measuring people's activities that we previously didn't measure and the value of those activities.

The only way we are able to keep real GNP near its base face values is by drawing people out of the home into the officially measured labor force.

And we don't measure the value of their raising children. We don't measure the value of their cooking meals, or other such activities.

We would start measuring their expenditures for child care. We would start measuring their purchases of food away from home and their cooking service.

We would start measuring their home repair—the things they can't do now.

That is the only way that official GNP can be near base face. I would say unambiguously true output of the country would be significantly lower, and that is why I emphasized this $600 per year loss per household.

Senator **Mitchell**. Thank you. Dr. Schink, on the question of the accuracy of such predictions based on models, in 1981 this committee received testimony that used a Wharton model to forecast the effect that President Reagan's tax proposal would have on the economy.

At that time, the Wharton model forecast several things: First, that the Federal budget deficit would be reduced to $30 billion in 1984.

The Wharton model also forecast, and I now quote:

> We estimate that as much as 56 percent of the individual tax cuts would be saved. It is this tendency to save which in the Reagan tax cut would fund much of the Federal deficit while curtailing the possibility of runaway consumption spending. As measured by the average person savings rate, the Reagan policy would sharply improve savings over the 1981-84 timeframe.

That is the end of the quotation from the Wharton testimony. Please forgive me for going back overtime, but I think it is relevant.

We all know what has happened to the Federal budget deficit and to the savings rate. In view of that record, would you tell us how much weight we should give to your testimony here today and the projections you have made? [Laughter.]

Dr. **Schink**. I think our analysis was as accurate as the administration's was, at least.

Senator **Mitchell**. That is not saying much, Doctor. [Laughter.]

Dr. **Schink**. I didn't prepare that analysis. I really can't comment on the specifics of it. There were a lot of statistics put forth by the administration in support of some positions, which as I recall the time we did that analysis, we gave the administration too much benefit of the doubt in doing the analysis.

Senator **Mitchell**. I obviously don't mean anything individually to you, but it is relevant for us to consider.

These are very rough aggregations and yet a great deal of political significance is going to be attached to the statements that you gentlemen are making here today.

Indeed, that is the very reason why you are here; and I merely want to point out that the underpinnings—the underpinnings—are very, very weak.

Thank you, Mr. Chairman.

The **Chairman**. Senator Grassley.

Senator **Grassley**. I want to ask mainly about agriculture and I know that you didn't touch on it; but in one of the areas, page 10 of Dr. Schink's statement, and then it is followed by the graph, there is an indication—if I am right—that agriculture would be at the top of the list of the negative impact of this bill on the cost to agriculture or the capital stock in agriculture.

I would like to know why is this so, and I would particularly like to have you elaborate for me on the implications for agriculture in the United States?

And because agricultural products, particularly grains, are so related in profitability to competing in world markets, the impact that that might have on our ability to compete?

Dr. **Schink**. Agriculture, capital costs, I think, do go up very significantly. I think many of the areas where the capital costs are increased the most are associated with the feedlot operations, as one area; and this has implications for grain markets.

Agricultural costs are on the top of this list and they are raised by cost above average; and agriculture, I think, suffers a significant negative effect because of this.

We did not do an indepth analysis of the agricultural sector for the House bill, but we did do an earlier analysis of the administration proposals and concluded that, in fact, agricultural costs would be increased and our competitiveness internationally would be reduced and that the farm income would be reduced significantly.

But I am quoting from a study I don't have in front of me so I can't be terribly more specific than that at this time.

Senator **Grassley**. Maybe I ought to ask a followup.

You mentioned extreme increase in costs of capital for commercial feedlots. Is that a large reason or just a minor reason for the increase in capital costs for agriculture as a whole because, if it is, let me suggest to you that for those of us from the upper Midwest, people who generally believe that the institution that we ought to maintain in agriculture are the family farms, we would see that a a positive.

If we could discourage outside investment in commercial feedlots, you know that is going to help the family farmer because that is unfair competition for us.

Dr. **Schink**. What this does in essence is reduce the after-tax rate of return to agriculture in general, and it affects not only the people who bring capital in from the outside, but those who in fact are investing their own family income.

Senator **Grassley**. OK, but you don't know the extent to which that might be attributable just to the commercial feedlot?

Dr. **Schink**. Some of the provisions of the bill clearly are designed to discourage commercial feedlot operations.

Senator **Grassley**. OK. Dr. Chimerine, you mention on pages 13 and 14 that models are extremely useful in calculating the industry and sectoral impact of macroeconomic changes.

I would like to have you comment, if the information is available, on the impact of the administration's proposal and 3838 on agriculture.

Dr. **Chimerine**. Senator, when I talk about calculating the impact on specific industries or sectors, I am talking directionally because, as Senator Mitchell has pointed out and I have pojnted out, it is very difficult to calculate anywhere near the precise magnitude of these impacts.

I don't have with me what the impact on agriculture would be, quite frankly.

As far as I can remember, it is not as severe as George Schink is suggesting; but I think it would be somewhat in the negative direction, but I don't have that with me.

I can check that and get back to you on that.

Senator **Grassley**. Dr. Brinner, does your organization have any information on that?

Dr. **Brinner**. We have not specifically evaluated the impact on agriculture.

Senator **Grassley**. Mr. Chairman, thank you.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. Thank you very much, Mr. Chairman.

Mr. Chairman, I was listening to my friend from Maine who I think is one of the brightest and one of the most able members of this Congress, but he also is an awfully good cross-examining attorney.

And as I listened to him question the credibility of the witnesses, what I finally got out of it was that, after 15 or 16 years, this legislation wouldn't be all that bad.

And that is what it added up to for me. But I am concerned about that next 15 or 16 years.

I am concerned about the international competitiveness of our country.

I look at a situation where, last year, our trade deficit was $140 to $150 billion, and the year before that $123 billion, and the year before that approximately $70 billion. The trend is not good.

I looked at a statement, Dr. Brinner, that you made less than a year ago for the Joint Economic Committee, talking about international competitiveness and the cost of capital. It was well received.

Now, one of the points in your statement was the dramatic difference in the cost of capital between Japan and here.

You cited things such as the fact that capital gains are not taxed in Japan. Profits distributed as dividends are lightly taxed. Real interest rates are substantially lower there.

And your conclusion was that, over the past decade, the cost of capital in the United States was 5.1 percent, but in Japan was far less—below 1 percent.

Is it still your feeling that the cost of capital is far less in Japan than in the United States? What about the capital costs in Europe?

And would you state again whether the House bill or the administration bill would help us or hurt us in our international competitiveness?

Dr. **Brinner**. Well, let me take them in sequence.

First of all, the number that you mentioned on the cost of funds, the real after-tax cost of funds in the United States averaging 5 percent and approximately zero for Japan.

The relevant number for my testimony here is that this bill would add ½ point to the U.S. cost of funds.

With respect to the current margin, rather than say the average margin over the most recent 5 to 10 years, it is true that the decline in interest rates that we have seen recently and the decline in inflation, combined with the accelerated depreciation provisions of the tax bill that is now in place, that combination has narrowed the gap between the United States and Japan.

I suspect that the number now for the total cost of using equipment and structures in the United States versus Japan has come to within 5 to 10 percent of the cost in the United States.

But those other numbers that I cited in my testimony, saying that the total cost of using capital goods in the United States would rise by 15 percent; those are exactly the comparable kind of numbers you want.

The progress that we have made would be wiped out by this bill, and that is lamentable.

In response to questions earlier in this hearing, I did note that I thought that the overall cost of producing goods in this country would be increased by some 5 to 6 percent; and that either has to be compensated for by a decline in our exchange rate, hence a decline in our standard of living relative to the rest of the world, or by an even worse trade deficit and higher interest rates to draw in the capital to finance that deficit.

Senator **Bentsen**. Of course, we know productivity increase is absolutely essential to increasing real income and trying to hold inflation in check and becoming internationally competitive.

But we have seen it grow erratically in this country. Since 1982, it has grown 6.9 percent in the nonfarm business sector. In the last year, it has been pretty well stalled.

And capital costs and capital investment play a major role in that.

Are you convinced that productivity has increased to a point in this country where we ought to reduce the incentives for investment?

Would you comment on that? Either one of you?

Dr. **Chimerine**. No. Quite the opposite, Senator.

As you point out, productivity growth has been very disappointing over the last year or 1½ years.

The capital spending boom is now petering out or flattening out.

We are certainly not doing well in world markets, and I think these are all the reasons why at least I have said, and I think my colleagues here have said several times, that we want to be very careful about implementing a major change in the tax structure now that could potentially worsen these problems.

I think sometimes we get too bogged down in specific numbers; but our big concern should be whether or not it will move us in the right direction toward solving these problems. And I don't think it would.

Dr. **Schink**. I would think we should move just the opposite way. Rather than consider protectionist legislation, we ought to be considering ways of helping to encourage the United States to become more productive to invest more in areas and reduce our costs rather than raise the cost of goods we import.

Senator **Bentsen**. Thank you very much, Mr. Chairman.

The **Chairman**. Senator Baucus.

Senator **Baucus**. Thank you, Mr. Chairman.

Gentlemen, I think this hearing is very significant for several reasons. The main reason is that this is one of the first times that a major tax bill has come before the Congress where the Congress is beginning to finally address international competitive effects that the bill might have on our economy.

I think for too many years we have assumed that the economic decisions we make here and any decisions we make on a tax bill only affect the United States within the confines of the Atlantic and Pacific Oceans and the borders of Canada and Mexico.

We all know that the world is changing dramatically, and I think it is absolutely vital that we address not only the distribution within our borders but also the effect that the tax bill has on our competitive position.

I say that because this bill—an analysis of this bill—the President's own Council of Economic Advisors in analyzing this bill—not once used the word "trade" or not once used the words "competitive position."

That is, they had no analysis of this bill with respect to our competitive position.

I might also add that the Treasury Department, in its analysis of the bill, did look at revenue estimates and various provisions of Treasury I and II and the House bill, but they made no estimate, no analysis of the effect of this bill on our international competitive position.

So, I salute you and I salute the chairman for focusing on this aspect of the bill because it is necessary that we do so.

As we analyze it, though, obviously we are chartering new ground. I mean, it is a new area for us as Americans; and obviously, too, it is hard to predict human nature.

It is difficult to predict the degree to which institutions, industries, and individuals are going to react to various provisions of the bill or react to monetary policy or react to other actions other countries might make.

But as we try to determine the degree to which, say, the House bill does increase capital costs and does impede capital formation in this country, particularly as that bears upon our international competitive position, I am wondering if you could flush out a little bit better the degree to which, all things being equal—as I know economists like to say—the degree to which, all things being equal, that higher capital costs in this country would necessarily decrease our competitive position?

What I am getting at is this: Some analysts say that, with the increased capital formation costs, that all things being equal the U.S. interest rates would tend to come down, and that will reduce

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the value of the dollar and, therefore, our trade deficit will diminish.

Now, as I understand you, Dr. Brinner, you say that may be true but that means a lower standard of living in the United States, and so we are worse off.

I wonder if you could just flush that out a little bit more. Go through your step-by-step analysis; I would like to hear that a little bit more.

And I would also like the other witnesses to respond to the same question.

Dr. **Brinner**. Let's begin with table 2 of my testimony. There I note that the after-tax value of depreciation on a present value basis under the House bill would be 27 cents per dollar of expenditure.

In other words, if you are a chief financial officer and you are considering spending some money on durable equipment that is going to be useful over a certain lifetime specified under the law, you would discount the value of those depreciation deductions; and then you multiply them by your tax rate. And that tells you the after-tax value of those allowances.

Now, the House bill for producers durable equipment would give you a value of 27 cents.

Senator **Baucus**. So, what you are saying then is that the cost is just going to be higher then?

Dr. **Brinner**. And that compares to 39 cents worth of value under the——

Senator **Baucus**. All things being equal, how will that affect the U.S. interest rates?

Dr. **Brinner**. U.S. interest rates are the price of savings; U.S. savings and national savings. That is how we attract them.

If we reduce total savings in this economy, we will raise our interest rates because we either have to borrow them from abroad, offer people more money to get their money here, rather than leaving it in their countries, or we have to do less investment.

And it is really the switch from personal to corporate taxation that causes interest rates to rise and that is the problem, as I noted.

Dr. **Brinner**. The personal tax cut itself cuts investment by one-third of the total package impact because of that impact on interest rates. You reduce savings. That means you must raise interest rates.

It is not the change in depreciation allowance that brings about that except through its impact on cash-flow and, hence, savings.

Senator **Baucus**. So you think that first, the bills increase capital cost; and, second, the only way that can be adjusted or accommodated is with either increased trade deficit or with exchange rate change so the U.S. dollar is lower and, say, the yen or other countrys' currencies are higher. And that reduces the American standard of living compared with other countries.

Dr. **Brinner**. That's right.

Senator **Baucus**. We do not have much time, but I wondered if very, very briefly the others could comment.

Dr. **Chimerine**. I would agree, Senator. I think the effect would be somewhat less than Roger Brinner states, but it would have

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some negative effect on our competitive—I would put it more like 2 percent instead of 5 or 6 percent when you take low productivity and higher capital costs into account, and this would either mean a higher trade deficit or a lower dollar.

Senator **BAUCUS**. All right. Dr. Schink.

Dr. **SCHINK**. In essence, the same reason as Dr. Brinner suggested. We see some increase in interest rates. I think a little less than his, but certainly the same direction.

Senator **BAUCUS**. But still the net result on exchange rates would be, say, higher dollar, but, nevertheless, lower U.S. standard of living compared to other countries?

Dr. **SCHINK**. That's correct.

Senator **BAUCUS**. Thank you.

The **CHAIRMAN**. Senator Chafee.

Senator **CHAFEE**. Thank you, Mr. Chairman.

Gentlemen, my primary concern is jobs for Americans. Is this legislation going to help provide jobs for Americans or reduce jobs for Americans in the next 5 years, in the next 10 years?

All right, Dr. Schink.

Dr. **SCHINK**. There will be a slight increase in the number of jobs, but as Dr. Brinner has indicated, you, in essence are going to be having jobs that are less productive because there is less capital to work with. So the real return to working is going to be down. So families are not going to be better off, but worse off. More people will have to work to earn the same real income because the workers will be less productive, earn less real income; therefore, more people will have to work to earn the same family income. I don't see this as a plus.

Senator **CHAFEE**. You would not see it as helping produce jobs?

Dr. **SCHINK**. There is a slight increase in employment, but that is misleading in that the return to working, real return to working, is lower because productivity is lower.

Senator **CHAFEE**. Dr. Chimerine.

Dr. **CHIMERINE**. I think in the first couple of years after enactment, Senator, unemployment would be higher. There would be fewer jobs than without tax reform. On a long-term basis, I think you would actually see the reverse—slightly higher employment, but slightly lower productivity and living standards.

Senator **CHAFEE**. Dr. Brinner.

Dr. **BRINNER**. I believe I have already indicated that there would be a slight increase in employment. I think that we are all in agreement there.

Senator **CHAFEE**. What is the solution to this? The capital investment situation that you talk about? If we shortened the depreciation schedules, in the House bill for example, and didn't touch the ITC, would that be helpful significantly or marginally?

Dr. **SCHINK**. It would be significantly helpful because you would not discourage business investment.

Senator **CHAFEE**. Accepting my thesis that we would not replace the ITC?

Dr. **SCHINK**. You would keep the ITC.

Senator **CHAFEE**. No. We would go with the House bill, which does not have the ITC.

Dr. **SCHINK**. I missed the——

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Senator **Chafee**. In other words, to be significant, it would not only require, as you see it, a shortening of the manufacturing equipment depreciation schedules, but also the restoration of the ITC.

Dr. **Schink**. They are both very significant, yes.

Dr. **Chimerine**. Or you can cut the corporate tax rate further. Fundamentally at least what I am talking about is to reduce the cost of capital and to reduce the decline in corporate cash-flow, you have to reduce the degree to which you are shifting the tax burden to corporations. You can do that by keeping the ITC. You can do that by more favorable depreciation. Or you can do that by a bigger reduction in corporate tax rates.

I would prefer keeping the investment incentives, myself, but you could do it any of those ways.

Dr. **Brinner**. You don't get the same bang for the buck from some investment incentives that you do from others. A corporate-rate type gives you one-half to one-third the investment bang for revenue buck loss as do investment tax credits and accelerated depreciation.

I argued that accelerated depreciation was inferior to investment tax credits because of two things. First, the accelerated depreciation gives you very arbitrary results. If inflation is surprisingly low, you would give a much more generous benefit than you intended. And, second, if you are struggling with a deficit problem today, accelerated depreciation is very much front-end loaded.

I would prefer to see adding back some inflation adjustment to depreciation. That is something that would give the same improvement in the present value of those depreciation allowances, something that a chief financial officer could appreciate, but it costs you money in the 1990's rather than in the late 1980's when you are trying to balance the Federal budget.

So I would say keep some portion of investment tax credits. Scrap accelerated depreciation. And if you want to do something for depreciation, add in some inflation indexation, cost to revenue, in the 1990's and not the 1980's.

Senator **Chafee**. On a scale of 1 to 10, balancing them, how much would you give to the importance for jobs for Americans to reducing the deficit of the country that it would be zero in 1991 versus adopting any form of tax reform?

Dr. Schink.

Dr. **Schink**. I think one of the key effects of having a large Federal deficit is, in fact, high real interest rates which has discouraged investment. I think reducing the deficit would allow real interest rates to come down further and further encourage expansion in investments.

The movement in that direction, I think, has a bigger longrun payoff than the kinds of twisting around of rates that we are seeing in the tax reform bill.

Senator **Chafee**. Could you quantify it in any way?

Dr. **Schink**. I would rather not.

Senator **Chafee**. Dr. Chimerine.

Dr. **Chimerine**. I would agree. I would put long-term deficit reduction as always the 10 or whatever for long-term employment in this country and living standards because I think you have to look at both employment and living standards. And I would put tax reform down one or two or something like that.

Senator CHAFEE. Dr. Brinner.

Dr. BRINNER. Reducing the deficit a 10; tax reform as currently proposed, a negative 10. [Laughter.]

Senator CHAFEE. With the objective being jobs for Americans.

Dr. BRINNER. Standard of living.

Senator CHAFEE. Standard of living.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

And, gentlemen, thank you for being with us this morning.

I guess what I am hearing here is that old adage that a lot of our constituents tell us that what is often popular in politics is oftentimes bad for economic policy and bad for the long-term growth of the country. Now I am not convinced yet that this so-called tax reform proposal is even popular politics, but it is established that somebody is for it. And I have not found them in my State, that there is much interest in it, but I guess maybe in some parts of the country it may be of interest.

But what you are all saying, if I hear correctly, is that this bill bodes ill for the next 10 years as far as the economy in the United States is concerned. Am I hearing you correctly?

Dr. BRINNER. That's correct.

Senator SYMMS. You are all nodding your heads affirmatively.

Dr. BRINNER. Yes.

Senator SYMMS. All right. Are you all familiar with the Hall-Rabushka tax reform plan, the flat tax?

Dr. BRINNER. Yes.

Senator SYMMS. How would you compare it with either the House bill or Treasury I or Treasury II on a scale of—would it be progrowth, projobs, productivity, international competitiveness?

Dr. BRINNER. I am trying to recall the dimensions. I believe that that proposal was genuinely revenue neutral on both the personal and the corporate side.

Senator SYMMS. It does away with double taxation.

Dr. BRINNER. And so I believe that that would be an improvement over the current structure, the currently proposed structure.

Dr. CHIMERINE. We have not done an analysis of it, but my guess would be we would reach the same conclusion, Senator.

Senator SYMMS. That it would be better economic policy?

Dr. CHIMERINE. In terms of long-term economic growth. It would probably be better than either of the two current tax reform proposals.

Senator SYMMS. Now Dr. Schink.

Dr. SCHINK. I would concur.

Senator SYMMS. That it is better.

Dr. SCHINK. We did not do an analysis on it.

Senator SYMMS. All right. Better than these. Now how is it compared with our current tax law?

Dr. SCHINK. As I said, we have not done the analysis. In principle, it does some things that should be attractive, but these things are complicated, and I would rather not speculate.

Senator SYMMS. All right. There are two other bills that are fairly—excuse me.

Dr. **Chimerine.** I was just going to make one other point, Senator. We have not discussed this at all today and I realize it is not the purpose of the hearings, but I think there is another issue that has to be taken into account when you consider that bill, and that's the effect on the distribution of income and equity issues. And I think you have to examine that bill from that standpoint as well.

Senator **Symms.** I think it is lacking in that area, although it is currently being rewritten to address that. But I am talking about economic policy for the country.

Dr. **Chimerine.** All right.

Senator **Symms.** Now there are two other bills that have gotten a lot of coverage. The distinguished Senator from New Jersey, Senator Bradley, and Congressman Gephardt have introduced a bill. Congressman Kemp, Senator Kasten, and others have introduced another bill. Are those bills—and I guess I should separate them. Let us just look at the Bradley-Gephardt bill. In terms of economic policy and maintaining international competitiveness, et cetera, cost of capital, the things that my colleagues have been asking about, would that bill be more sound, better economic policy or worse than the House bill?

Dr. **Brinner.** We have prepared analyses of both of those bills in very specific analyses. Not the updated Kemp-Kasten bill, but the original one. And I would be happy to give the committee copies of those. We did those about a year ago. And I hestiate to try to recall the exact effects.

Dr. **Chimerine.** My recollection—it has been so long since Senator Bradley and Congressman Gephardt introduced their first bill—is it does not result in a significant shift in the distribution of the tax burden away from individuals toward corporations. Is that right? It was sort of revenue neutral for both. And when we did work, and this goes back quite a while, I think our conclusion was that for that reason it would be more favorable for long-term economic growth and international competitiveness than either of the two proposals that we are discussing today—the administration's and the House bill.

Dr. **Schink.** To the extent that any bill doesn't shift the burden of taxation toward corporations and away from individuals would have a positive longer run effect because the negative effects that we are obtaining are largely due to discouraging investment by corporation. To the extent that you didn't increase the tax burden on them, it would be a positive relative to this.

Dr. **Brinner.** Just a real quick followup. We do have to look at the structure of corporate taxation; not just the total level. Because, as I mentioned, there is a different bang for the buck, from rate reductions and from the specialized incentives.

Senator **Symms.** Is it correct to take as your summary of this morning that 3838, then, is generally anticapitalistic? [Laughter.]

The **Chairman.** Do you think it is communistic? [Laughter.]

Senator **Symms.** No; I didn't say that. Just anticapital.

Dr. **Brinner.** It is anticapital formation.

Dr. **Chimerine.** And antiquantity of capital spending, yes.

Senator **Symms.** All right.

Dr. **Schink.** It is anti-investment.

Senator **Symms**. All right. Now the next question is: Is it fair to say that it further complicates the Tax Code or makes it more simple? Which way would you put it? Is it simpler or more complicated?

Dr. **Schink**. I think it is just different. [Laughter.]

Senator **Symms**. But it is certainly fraud to call it simpler, though?

Dr. **Schink**. I don't think it would be much simpler.

Senator **Symms**. All right.

Thank you.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman.

Mr. Chimerine, you said in your testimony on page 30 "tax reform is a good idea." You define it as lowering rates and broadening the base. And you go on to say it could make the tax system simpler and a lot fairer; it could reduce some of the distortions in the economy. But reducing the budget deficit is an even better idea. In fact, perhaps, the best way to achieve a healthier, stronger economy is to combine tax reform with deficit reduction.

Now could you explain to the committee how those two initiatives would interact, and what each would do for the economy?

Dr. **Chimerine**. Well, I view tax reform, Senator, primarily as a way to make the tax system fairer. If we get some incentive benefits from it and efficiency benefits, that is even better, and that, maybe in the long term, can happen to some extent as well.

But, quite frankly, my main interest in tax reform is to make the system fairer. And the best way to stimulate long-term economic growth is to bring interest rates down sharply on a long-term basis, and to reduce the value of the dollar on foreign exchange markets.

I do not think that is possible without sharp deficit reduction in the United States. Deficit reduction has become counterproductive for economic growth because the negative effects associated with high interest rates and the dollar are now offsetting whatever direct stimulus we get from deficits and as a result if we can find some way to do both together, make the tax system fairer, share the tax burden more equally, and at the same time reduce the deficit, I think that is the most favorable combination to address our economic problems simultaneously and foster long-term economic growth.

Senator **Bradley**. We have discussed today in the committee at some length the issue of cost of capital as a part of the international competitiveness issue. And I think it would be helpful to get to the components of cost of capital. For example, in response to Senator Moynihan's question, Dr. Brinner said that you predict that with the House bill or the Treasury II the cost of capital would become double digit. And he asked, when that happened the last time, and if it had ever happened?

And you said, well, it has happened the last several years because we have had very high real interest rates. And I would assume that you would also agree that the cost of capital was also high in the 1970's because there was high inflation.

So the question is: The components of cost of capital, one of them is interest rates. Is that correct? Would all of you agree?

Dr. **Chimerine**. Yes.

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Senator **Bradley**. Dr. Schink.

Dr. **Schink**. Yes.

Senator **Bradley**. Dr. Brinner.

Dr. **Brinner**. Yes.

Senator **Bradley**. One of them is inflation. Would you agree?

Dr. **Brinner**. Yes. It raises the level of interest rates, but you can get an offsetting benefit.

Senator **Bradley**. Now would you agree that taxes are a component as well?

Dr. **Chimerine**. Yes.

Dr. **Brinner**. Yes.

Dr. **Schink**. Yes.

Senator **Bradley**. Would you agree return on investment or what is used as an acceptable return of investment; that is, profits, is a part of the cost of capital?

Dr. **Chimerine**. Well, in a sense, there are two ways of looking at the same thing, Senator. That is, you have an expected return on investments that comes—we look at it without taking into account the cost, and what the company does is compare the expected return based on the profitability to investment with the cost of financing the investment. So I think there are two separate things.

Senator **Bradley**. But the point is that when we talk about cost of capital, we are talking about four or five different things, only one of which is the tax system.

Dr. **Chimerine**. Correct.

Dr. **Brinner**. Correct.

Senator **Bradley**. When we talk about relative cost of capital in an international context, those become particularly relevant.

Dr. **Chimerine**. Absolutely.

Senator **Bradley**. If you recall the testimony before this committee during the hearings last year, Japan does not have an investment tax credit. It has less generous capital cost recovery systems than we have in this country. And yet you have testified—and this is a disputed claim—that Japan has a lower cost of capital than we do.

Other economists who have been before this committee have disputed that. And my only question to you is as we look at this whole package of cost of capital, would not it be far more effective—and I think you have testified to this Dr. Chimerine—to get interest rates down? Wouldn't we be much better off to have interest rates drop than we would be to continue to oversubsidize capital through the Tax Code?

Dr. Chimerine.

Dr. **Chimerine**. Yes. But I am not convinced that implementing that tax reform proposal by itself, Senator Bradley, without deficit reduction would produce significant enough declines in interest rates. But to answer your question, the answer is yes.

Senator **Bradley**. So, if we had deficit reduction and an accommodating monetary policy, then the cost of capital would drop significantly. Is that correct?

Dr. **Chimerine**. Without question.

Senator **Bradley**. Thank you.

The **Chairman**. Senator Pryor.

Senator **Pryor**. Thank you, Mr. Chairman.

Some have been asking some of the members of the committee what their hot button item issues were in the tax bill that we had to consider. And all of us have some of those. And one of those issues that concerns me is the issue of localities and the ability to finance local government, especially with the demise of the revenue-sharing program, apparently, and with the implementation of Gramm-Rudman.

I assume that State and local governments are going to be in a real bind about 1 year from now. And my question is:

As I have looked briefly through your statements, I do not see a treatment nor any discourse on the issue that I can find in your statements on the tax-exempt bond arena. Have we done anything on this, and did I overlook that and the impact that it might have on the abilities for local governments to raise money?

Dr. **Brinner**. We did not include it in our analysis, but we did take into account the changes in tax-exempt bond financing provisions. And that certainly would raise the cost for some State and local government activities.

The other area of the tax plan that might affect State and local governments is the deductibility of their taxes on the Federal return. But remember that the deductibility issue does not change the taxes collected by those State and local governments. It changes the tax that the Federal Government collects. Therefore, unless there is a taxpayer revolt that forces States to cut their tax rates, you wouldn't see tax revenues reduced at the State-local level.

And that taxpayer revolt would certainly be cut into by the reductions elsewhere in the Federal tax on personal income. Remember, this is an overall giant personal tax cut. So what the Federal Government is taking out with one hand from a household's pocket, it is more than putting in with the other hand. So I don't really buy the notion that there would be a revolt of personal income taxpayers.

Senator **Pryor**. I am not talking about the revolt by the taxpayer. I am talking about the ability to finance some projects, like sewer systems, local schools, et cetera, with tax-exempt bonds. And that is my question. I may not have made that clear.

Dr. **Brinner**. Certainly, there is a subsidy there, and the only debate is whether that is the most efficient way to subsidize that activity or whether it should be done by direct expenditure programs.

Senator **Pryor**. I wonder if our other panelist might have a comment on this issue.

Dr. **Chimerine**. Well, I think, Senator, you are correct; it would obviously make it more difficult to finance some of those projects. Quite frankly, in terms of the impact to the overall economy, it won't be that dramatic. It might cause some serious difficulties for some specific local governments.

And I tend to agree with Roger about the effect of the elimination of State and local deductions in general as being an overblown issue as well.

Dr. **Schink**. I think the implications of Gramm-Rudman ultimately may be bigger in the sense that there will be cutbacks in specific Federal programs which will put States into the position of having to raise taxes.

The **Chairman**. Excuse me, I cannot hear your answer.

Dr. **Schink**. I think the ultimate implications of Gramm-Rudman may be more severe and that certain programs will be cut back that would, in fact, require States to increase taxes to continue them. And I think that could be more serious.

The changes in the rules regarding municipals, the House bill moved further toward, I think, allowing more of this than the administration proposal. In a sense, that would have less of an effect.

Senator **Pryor**. Mr. Chairman, I am going to yield back the balance of my time. I have to leave. Thank you very much.

The **Chairman**. Senator Wallop.

Senator **Wallop**. Thank you, Mr. Chairman.

I think we've witnessed a first here this morning. There is more agreement amongst economist than I usually get to witness. I have heard them all three answer questions from both sides virtually alike in many respects.

I think when we are talking about the cost of capital in Japan, isn't it true that one of the reasons why it is deemed to be lower there is because there is no double taxation on corporate income?

Dr. **Brinner**. There is less double taxation than there is here.

Senator **Wallop**. Dividends and other things are hit.

Dr. **Brinner**. Yes.

Senator **Wallop**. Is there any way in which it can be argued—and I just toss this to the three of you—that these bills do not increase the cost of capital?

Dr. **Brinner**. No. I cannot imagine a way that you could argue that these bills would not increase the cost of capital.

Senator **Wallop**. Well, given that, what types of changes would really be necessary for us to eliminate that ill effect? And the ill effect, I think, is we describe it in one way is losses in productivity and standards of living and other things. What would we do to eliminate that first?

Dr. **Brinner**. I know I am swimming upstream here because I am arguing that you get a smaller bang from the buck from corporate rate cuts, but, boy, that sure seems to be a favorite item, than you do from an investment tax credit. I read daily that the investment tax credit is dead, and that one change might be a further reduction in the corporate rate. I think that is a mistake. I would resist it. I would try and swim upstream on that issue.

And I would also try to rebalance the whole change so that less of a cut is achieved for personal income taxpayers and more of a gain is given to the corporate sector.

Dr. **Chimerine**. I would agree with that, Senator. I would reduce the degree to which the tax burden is shifted, and on the corporate side, my preference too would be to accomplish that by not eliminating investment tax credit entirely or doing so for a long period of time instead, and by making depreciation somewhat more generous than it would be under the House proposal.

Dr. **Schink**. I concur in essence that the burden should not be shifted to corporations away from individuals. And I think in terms of the types of changes you make, we have done studies, numerous studies, over the years, and they have consistently said the investment tax credit gives you the biggest positive effects on investment for dollar cost to Treasury followed by different methods of accelerating depreciation, followed finally by across-the-board corporate tax cuts.

So you have to give corporations a lot more dollars back in the form of straight corporate tax cuts to get the same impact on investment as you would by going to the investment tax credit.

Senator **Wallop**. Well, let me ask you this, because I have heard nobody address it: But where does the minimum tax come into this in terms of efficiency, cost of capital?

Dr. **Chimerine**. Can I take a crack at that, Senator?

Senator **Wallop**. Please do.

Dr. **Chimerine**. I think you have raised a good point because there is a way of keeping—you know, you can keep the investment tax credit and have more favorable depreciation. At the same time, limit the amount any individual corporation can use those tax preferences by enacting a reasonably stiff minimum tax. So that, you know, you do want to make the tax system more equal across industries. And I understand that. And I think that is reasonable.

And one way of doing it is to limit how much tax preferences any individual corporation can take without necessarily eliminating the investment tax credit completely. So I think the combination of maintaining some of those incentives, but having a reasonably effective minimum tax so nobody can get away with paying nothing, is the right combination.

Senator **Wallop**. Well, how does it help to give it and take it away in the same——

Dr. **Chimerine**. Oh, you don't take it away. If you have the minimum tax at 15 percent or 10 percent, or whatever, instead of effectively zero, which now currently exists for some, you are still enabling many companies to take advantage of the investment incentive without, you know, letting it become abusive or excessive. So it is a question of limiting their use; not eliminating them completely.

Dr. **Schink**. The intent of investment tax credit is not to allow corporations or individuals to pay zero tax. A lot of the financial games that get played, that people are upset about, are what lead to that.

I think the minimum tax is very attractive and it doesn't require that you try to anticipate how people are going to sneak, you know, around the provision in the tax bill. You know, they can sneak so far and beyond that they have to pay a minimum tax. So it has a lot of attractiveness both on the corporate and the personal side in that. You at some point say, you take in so much income, you pay at least this much tax. And I think it does away with some of the more serious abuses without having to anticipate specifically what they are.

Senator **Wallop**. Do you agree with that?

Dr. **Brinner**. Yes, very much. A minimum tax really, genuinely adds to the perception of fairness of the Code. But I also agree with your comments on the conclusion that capping those incentives does reduce their total value, but that is a tradeoff I am prepared to make.

Senator WALLOP. Why wouldn't it better just to cap the incentive? And I just will tell you that this committee spent the whole morning trying to figure out how to get people out from under a minimum tax in the case of bankruptcy in agriculture. I mean it is as hard to define as other things. Is there another way in which it can be accomplished?

Dr. BRINNER. I proposed a 5-percent investment credit to replace the current 10 percent. That certainly would pull out a large number of companies from, you know, any kind of ceiling conflict with an investment tax credit.

Senator WALLOP. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Long.

Senator LONG. Dr. Brinner, I was surprised to hear you say that the real cost of funds for business expansion in the United States is 5 percent and in Japan it is zero percent. Is that what you said?

Dr. BRINNER. After inflation and after tax.

Senator LONG. In other words, what the Japanese are getting in interest rates is just enough to make them hold against inflation. Is that what was said?

Dr. BRINNER. That is correct.

Senator LONG. That is amazing to me, but I did not hear anybody challenge that. Is that right, Dr. Chimerine?

Dr. CHIMERINE. I could not tell you if the precise numbers are correct, but directionally that is right.

Senator LONG. Is it substantially correct?

Dr. CHIMERINE. OK.

Senator LONG. Is that right, Dr. Schink?

Dr. SCHINK. I would agree, yes.

Senator LONG. What you have told us then, is that we already have a bad disparity to overcome assuming you believe in free trade.

Then you go beyond that to a bill that makes it worse because it further increases the cost of capital. Is that right?

Dr. BRINNER. That is absolutely correct.

Senator LONG. So you are saying that if you want to to reduce the trade disadvantage we are suffering, you ought to be trying to bring down interest rates. This bill does nothing about that because it——

Dr. BRINNER. Reduces savings.

Senator LONG [continuing]. Does just the opposite. It reduces savings because it does nothing about the interest rates. That is, it does not reduce the deficit.

Dr. BRINNER. That's right.

Senator LONG. By failing to reduce the deficit, the bill makes no contribution toward cutting interest rates.

Dr. BRINNER. Paul Volcker has testified that a $50 billion reduction in the deficit would bring a point reduction in interest rates. That will scale that one for you.

Senator LONG. Do you agree with that generally, Dr. Chimerine?

Dr. CHIMERINE. Yes. This bill will not significantly reduce interest rates on a long-term basis.

Senator LONG. Do you agree with that, Dr. Schink?

Dr. SCHINK. I would agree.

Senator LONG. The President wants a bill. My guess is that he is going to get a bill. I am not sure whether it ought to be that way, but if that is how it is going to be, I would tend to be against any combine I am not in on. [Laughter.]

So, maybe I had better get with it.

If we are going to do something in the national interest, it would appear to me, based on your testimony, that we should reduce the bill's heavy impact on business which impact would make us less competitive and cost us jobs. Basically, is that what you think?

Dr. BRINNER. That is correct.

Senator LONG. And you think that too, Dr. Chimerine?

Dr. CHIMERINE. Absolutely.

Senator LONG. Do you agree, Dr. Schink?

Dr. SCHINK. I agree, yes.

Senator LONG. Thank you very much.

I would like to get one more thing straight. Would you tell me succinctly your opinion as to why the 1981 tax cut didn't have the short-term results predicted?

Dr. CHIMERINE. On what?

Senator LONG. Well, the 1981 tax cut was eventually a 25-percent cut in rates.

Dr. CHIMERINE. Right.

Senator LONG. It offered a big advantage to capital accumulation mainly by way of the ACRS. It was predicted to give us a big boost in the economy, and it did just the opposite. Why do you assume that happened?

Dr. CHIMERINE. Well, I think there were a couple of reasons, Senator. First of all, in the short term, the recession that occurred in 1981 and 1982 after the tax bill was enacted was primarily because of tight money, extremely high interest rates. I think the passage of the tax bill made interest rates even higher because the market started to anticipate these big deficits, but it was mostly a monetary policy phenomenon and a continued response to previous increases in oil prices.

It then did have some stimulative effect on the economy in 1983 and 1984, but it did not push up savings. On a long-term basis, it has probably helped investment a little bit. I don't think it has pushed up the labor force. So it has not had the long-term supply-side impacts. The 1981 tax bill, in my judgment, has not improved long-term growth prospects in the United States.

Senator LONG. Here is the way I heard it. When the 1981 bill was analyzed on Wall Street, the consensus was that it was going to give us very large deficits for a long time to come. And that was correct.

Dr. CHIMERINE. Absolutely correct.

Senator LONG. The long-term deficits were going to be inflationary and, thus, there were going to be higher interest rates. Once you cranked the higher interest rates into your computer, the stimulus in the 1981 bill could not overcome the high interest rates and, thus, the higher cost of capital.

Thus, while the tax changes would cut the cost of capital, the higher interest rates snuffed out any gain.

Dr. CHIMERINE. After the initial short-term surge, you are absolutely correct.

Senator **Long**. Is that what you thought also, Dr. Brinner?

Dr. **Brinner**. Congress and the administration had their foot on the accelerator; the Federal Reserve and the OPEC nations had their foot on the brakes.

Senator **Long**. Is that your thought, Dr. Schink?

Dr. **Schink**. That is correct; yes.

Senator **Long**. The point is that it was a case of stepping on the accelerator and stomping on the brake at the same time, and the pressure on the brake was greater.

Thank you.

The **Chairman**. Now let me follow up on this theory. In 1981, those who loaned money long term thought, "holy mackerel, this tax cut is going to lead to immense inflation and we are going to peg our long-term interest rates," and by that, I mean 5 years or more, accordingly.

And most of you—I think all of you have testified today that we might expect converse if people think we are going to narrow the deficit, and they really believe it.

Now under Gramm-Rudman—and I think we are going to hit those $144 billion totals. In fact, I was stunned yesterday to hear Director Jim Miller indicate that the cut next year may not have to be more than $40 or $45 billion because of the budget authority we are cutting now with just this little $11.7 billion outlay cut we are making in 1986.

If, indeed, those who loan money long term think, after the Court decides and say they find it constitutional, holy mackerel, they are going to reduce the deficits, can we expect the interest rates to drop?

Dr. **Brinner**. Yes. There is some very good evidence that you might look at. There is something called the Decision Makers' Poll that asks bond traders, stock traders, chief financial officers what do they think inflation is going to be over the next 10 years; what do they think the Government deficit is going to be over the next 10 years. And then it translates all that into interest rates and after-inflation interest rates.

And the latest poll has come out. It shows that because of Gramm-Rudman, those money market activists believe the deficit is going to be cut, and they believe inflation is going to be lower than they thought a couple of years ago. And we have seen a pronounced decline in long-term interest rates over the last 3 to 6 months because of that change in expectation. They don't fear inflation as much, and they don't fear such fierce competition for funds.

The **Chairman**. And this is even before it is in effect.

Dr. **Brinner**. That's right.

The **Chairman**. I mean if we really come to next September and either the Congress has come to a budget with the President or he sequesters it and we hit 140, and looking at 108, and they think it is going to happen, you expect they will come down even further.

Dr. **Brinner**. That's right.

Dr. **Chimerine**. I would agree. There has already been some anticipatory effect in the long-term markets, and I would expect substantial additional declines if you come close to those deficit targets.

The **Chairman**. Dr. Schink.

Dr. **Schink**. Yes, I would agree.

The **Chairman**. Do you want to quantify it?

Dr. **Brinner**. Yes.

The **Chairman**. How much?

Dr. **Brinner**. I think that Paul Volcker gave you a good ballpark estimate at least a year or so ago.

The **Chairman**. That was a year or so ago.

Dr. **Brinner**. Those numbers are still pretty good. The real interest rate today on long-term bonds, according to these decisionmakers and their expectation is about 5 to 5½ percent. Normally, that would be 2 percent. So they have got 3½ points that you can trace to the deficit. You have got a $200 billion deficit. Divide 200 by 3½ and you have got 1 point for $50 billion.

Dr. **Chimerine**. I would say it would be less than that, Senator, because I think there have been some changes in financial markets that probably have permanently raised real interest rates.

But I would say if you come close to those targets for the next year or two, long-term interest rates will drop upward of 2 percentage points from where they are now.

The **Chairman**. Dr. Schink.

Dr. **Schink**. I tend to concur with Dr. Chimerine. It wouldn't be quite that big, but it certainly would be about—

The **Chairman**. So we are talking in a 1- to 2-percent range over—

Dr. **Brinner**. Yes;

The **Chairman**. Once everybody believes the process is going to work—I don't know when that is—but once they believe it.

Now further question: Does it make any difference if we narrow the deficit by spending cuts or by tax increases?

Dr. **Brinner**. Yes; it does. Spending cuts or direct purchases slow down the economy more rapidly because that takes it right out of final demand immediately. Spending cuts are reduced. Transfer payments are almost identical to tax increases because it takes money out of people's pockets.

The **Chairman**. I mean on interest rates. Does it make any difference whether we do it by spending cuts or by tax increases?

Dr. **Brinner**. Yes, because the economy has slowed down more rapidly with the spending cuts. And that also contributes to a decline in interest rates.

The **Chairman**. So spending cuts will make them drop further or faster or both?

Dr. **Brinner**. That's correct.

The **Chairman**. Dr. Chimerine.

Dr. **Chimerine**. Slightly, Senator. But I might make one quick additional comment on that. I think the markets believe that you can't reach those deficit targets without some tax increases. So if there is no talk of tax increases, it is going to keep the market more skeptical and it is going to keep interest rates higher than they would have been in anticipation of a deficit reduction.

The **Chairman**. Which means if we actually make it by spending cuts there ought to be a precipitous drop in that case because we would have done something they don't believe.

Dr. **Chimerine**. You are absolutely correct. I would agree with that completely.

The **Chairman**. Dr. Schink.

Dr. **Schink**. I think the spending cuts, because of the fact the economy would be slower or at least more demand on credit markets, you would get a bigger effect on interest rates. But I think the perception—you know, the reluctance to consider tax increases has, in fact, I think, made the players in the financial market skeptical about the ability to make it. I think they are fairly realistic in their appraisal of how much can be cut.

The **Chairman**. Last question. Assuming you are going to do it by spending cuts, does it make any difference what kind of spending cuts they are?

Dr. **Brinner**. Only marginally insofar as whether it is purchases of goods or transfer of payments.

Dr. **Chimerine**. I would agree. Very marginal. Except for the statement "big ones." You will need big ones.

Dr. **Schink**. I would agree.

The **Chairman**. And if we do it with tax increases, would it make any difference what kind of tax increases or is that also marginal in terms of interest rates?

Dr. **Brinner**. Yes. It does make a difference. Corporate tax increases will draw on savings or reduce savings. A personal tax change primarily affects consumption; not savings.

The **Chairman**. And the corporate tax increase would—if you do it with corporate tax increases, your interest rates will not drop as fast or they might go up.

Dr. **Brinner**. That's right.

Dr. **Chimerine**. I would agree.

Dr. **Schink**. I would agree.

The **Chairman**. Senator Heinz.

Senator **Heinz**. Mr. Chairman, thank you.

I would like to ask you gentlemen a little bit about the international competitiveness issue that has returned time and again. I come from a State, Pennsylvania, where—and two of you do too, where whether it is our basic industries, such as steel, electrical equipment, or whether it is high tech industries, are affected by international competition quite aggressively. Indeed, a recent study I saw showed that we are at some international competitive disadvantage if you view a shift downward in market share as being significant in 7 out of our 10 high technology industries.

Now we talked earlier about the exchange rates. And I think it may have been Dr. Brinner or Dr. Schink who said we will have an impact on our standard of living if we have to see the dollar weaken. There was an implication that if the dollar weakened relative to other currencies you necessarily took a directly related cut in standard of living. Is that a 1 for 1 or is it something less than that?

Dr. **Brinner**. A reduction in the exchange rate would help support employment, and that would tend to support our absolute standard of living. But it would, of course, by definition, cut our standard of living relative to those overseas once your convert everything to a common currency and common purchasing power.

So you have to keep track of what is absolute and what is relative to the rest of the world.

Senator **Heinz**. And your point further was that a lot of people would be sucked into relatively low value-added jobs, which would nonetheless still overstate the GNP because presumably people who are now not employed and are doing something valuable at home would be forced out of the home to make ends meet.

Dr. **Brinner**. Or simply if I cook a meal for my children, the value of my time in that cooking is not counted. If I go to McDonalds, they might be happier with the food than if I cook it, but the value of the McDonalds' cook is counted in GNP.

Senator **Heinz**. Yes.

Dr. **Chimerine**. Senator, can I make a comment on that?

Senator **Heinz**. Yes, Dr. Chimerine.

Dr. **Chimerine**. I am not sure really what Roger is getting at, but in my judgment I think a significant additional decline in the dollar from where we are now would benefit the economy. It would primarily by stopping the loss of these high-paying manufacturing jobs that has been spreading dramatically because of our weak international competitiveness.

My big concern is the way to get the dollar down is not to increase the cost of capital. The way to do it is to reduce interest rates.

Senator **Heinz**. Dr. Schink, you have a comment on that?

Dr. **Schink**. I wanted to support Dr. Chimerine's statement. I think what Dr. Brinner was indicating in all else being equal—exchange rates—it raises the prices in this country and reduces the standard of living. But I think the sequence of events we would all like to see is, in fact, a reduction in the Federal deficit; thereby, a reduction in real interest rates. In part, because it would not have to be competing for international funds and which would allow the value of the dollar to decline and create jobs in this country.

And I think that is a positive package of events that I think we would all support.

Senator **Heinz**. I want to follow up on that. I think there are many of us who are concerned about the cost of capital—industrial competitiveness. You have heard the concerns. Should we hold the tax reform bill hostage to deficit reduction? Dr. Chimerine?

Dr. **Chimerine**. My preference would be to combine the two, if you can, because I think that is the most logical way to generate the added tax revenues you are going to need as part of the deficit reduction program. So I will answer your question by saying I think the logical step would be to combine the two.

Senator **Heinz**. You have a good future in politics. [Laughter.]

Senator **Heinz**. Dr. Brinner.

Dr. **Brinner**. I would not hold it hostage. I would make some adjustments to make as close to revenue neutral on both the corporate and the personal side. And if you happen to make a mistake and gain $5 billion in revenue through this tax reform, good for you.

Senator **Heinz**. Dr. Schink.

Dr. **Schink**. I don't think holding it hostage is really the issue. I think the focus of attention really ought to be on how are we going to reduce the Federal deficit, how are we going to improve our international competitive position. And to the extent that this bill does not help our international position, competitive position, or help reduce the deficit, I don't think it should be enacted.

Senator **Heinz**. My time has expired. I think we will state the point of view that I don't think that we should embark on tax reform no matter how good it may be without also moving ahead with deficit reduction at the same time. Whether that means holding this hostage or not, I don't know, but if that is what it takes, I am willing to do it.

The **Chairman**. Senator Mitchell.

Senator **Mitchell**. I thank you, Mr. Chairman.

I would merely like to first note for the record that Dr. Brinner's statement regarding the relative cost of capital in Japan is a disputed contention. We ought not to accept it as a fact. Indeed, before this very committee another economist, Alan Auerbach, recently testified, and I will just read one brief paragraph from his testimony. He says, and I quote:

> There is a view held by many that the current problem facing U.S. firms in their economic battle with foreign counterparts, notably Japan, is the relatively heavy burden of capital taxation in the U.S. I am aware of no evidence to support this proposition; nor is there convincing evidence that other factors give the Japanese a lower cost of capital.

I don't want to debate that now, because I have other things. But I just wanted to note for the record that what was asserted here is obviously a sincere opinion, but there are others who hold sharply conflicting views, and we ought to take those into account.

And I will now get to a question which deals with the same principle. That is, there are other studies, as I am sure you all are aware who have reviewed this tax reform bill and reached a conclusion that is opposite of yours regarding its overall effects. These studies take into account efficiency gains that result from more uniform tax treatment of different needs. Among those who have conducted such studies and who reach a conclusion different from yours are the Council of Economic Advisors, the American Enterprise Institute, and the Congressional Research Service.

The Congressional Research Service, for example, studied the business tax provisions in the President's tax proposal. I know it is often called Treasury II here. I think it is probably useful that we identify it for what it is—the President's tax bill.

And it found efficiency gains of as much as 1.1 percent of output which are comparable to 7.3 percent increase in capital stock.

Now I would like to have you tell us how your models accounted for efficiency gains obtained from the more uniform treatment of assets under the tax reform bills under question. I hope you could do so concisely because we only have 5 minutes, and I have a couple of other questions I would like to ask.

Dr. Brinner, go ahead, sir.

Dr. **Brinner**. There is an established body of—where it tells you just how to measure those. And we did factor in something like three-quarters of a percentage point gain in productivity due to the greater efficiency. We took the received literature approach. It is basically arithmetic. Factored that in, and the productivity losses that I note are net of that positive adjustment. There isn't a disagreement that there would be efficiency gains. I don't think there is even a disagreement of the size of those gains. It is just a question of whether you also look at whether the volume of investment is going to be moved up or down and add that in.

I don't believe that the Council or the American Enterprise Institute took into effect the impact on the total capital stocks. They assumed that those would be the same, and then just looked at the efficiency gain.

Dr. **CHIMERINE**. I would answer that question in the same way, Senator. That it is a tradeoff between the volume of investment spending and the efficiency associated with it. And you have got to remember that it takes a long time to change the capital stock in this country, and you cannot increase productivity growth resulting from efficiency gains as rapidly, in my judgment, as some of those studies would suggest.

The truth of the matter is we really don't have a good handle on how large those efficiency gains will be. My best guess, as I said earlier, would be if we are lucky, there will be enough to offset the effect of reducing investment, but I must tell you there is no strong evidence despite the studies you cite that it will be, on a net basis, favorable.

Senator **MITCHELL**. Thank you.

Dr. Schink.

Dr. **SCHINK**. We also factored in the efficiency gains resulting from not in essence subsidizing certain investments, but this is overdone or overrun, I think, by the fact that the cost of investment on average is higher.

You put less investment in place, and you may allocate it slightly more efficiently, but there is such a large capital stock in place you don't really see much in the way of gains for many years. So we are talking net effects recognizing some of this. I think the other studies, in essence, focused on one aspect; not on the total aspect.

Senator **MITCHELL**. Your testimony today refers to a shift in the tax burden from individuals to corporations and the adverse effects you see from that. According to some analyses of the House bill, most of the increased tax burden for corporations are concentrated in some very specific industries that are not now paying any significant amount in Federal taxes.

For example, out of the $139 billion in increased corporate taxes over the 5-year period beginning in 1986, only about $30 billion is associated with general business. About $60 billion is raised through making changes in accounting provisions which affect long-term contracts in such industries as defense and utilities, both of which it is argued make investment decision independent of tax considerations. And also increases burdens on other sectors where effects to the capital investment, our domestic business, are unlikely or at least different from standard cash-flow effects.

Now my question is: Did you deal with this in your model? If not, why not? And if so, how did you do so? Do you agree that such differentiation must be made to validate the conclusions?

Dr. **BRINNER**. I would say that we dealt with it, but probably not comprehensively. About half of the impact that we have on investment is due to a cash-flow effect in the model. That may be overstated. The rest is due to the change in the specific incentives like investment tax credits, accelerated depreciation. That is done carefully. We look at utilities separately, for example, in the models. I don't think we have erred there.

I would have to agree that if we went back and redid the analysis to try and differentiate by industry of the cash-flow effect, I would also then bring into the picture the more detailed models of office, hotel, and other nonresidential structure constructions which indicate to me a very large downside risk.

My guess is that I would come out to an even lower number than I presented today for total capital formation.

Dr. **Chimerine**. We tried to take it into account, Senator, and maybe one of the reasons why we are not as pessimistic as some of the others is because it won't hold down capital spending as much as some of the others might be suggesting. But when you add it all up, it is still a negative. The total volume of capital spending, because total cash-flows will be down significantly.

Even in some of the industries that are not just being affected by accounting changes.

Dr. **Schink**. We looked at the impacts on industry-by-industry basis, and while it is true that some industries are more sensitive to capital costs than others, I think we disagree that industries are, defense-related industries, are insensitive. Our historical analysis suggests that isn't correct.

Senator **Mitchell**. Well, my time is up, Mr. Chairman.

The **Chairman**. Senator Chafee.

Senator **Chafee**. Thank you, Mr. Chairman.

Gentlemen, Dr. Chimerine said that we should seek fairness in tax reform. I think we all agree with that. Tax reform, obviously, should seek fairness and hopefully there should not be a downside to it resulting in a decline in the standard of living. All of you believe the House bill decreases the standard of living in the United States.

Now is this legislation beyond redemption or can we do something about it? In other words, you spent most of your time on capital formation. Assuming we straighten that out, whether we take Dr. Brinner's suggestion of restoring the investment tax credit at 5 percent and improving the depreciation schedules or whatever. Let's assume we can improve the capital formation provisions, then what would your position be? Are there other major changes you would suggest?

Let's start with Dr. Chimerine.

Dr. **Chimerine**. I would be very much in favor of this, Senator, relative to the current tax system. I think it could be improved further, quite frankly, but nonetheless, it would be——

Senator **Chafee**. State if you would, where you believe it should be improved further, other than the——

Dr. **Chimerine**. Well, the first major change is the one you talked about; namely, you have to be willing to not reduce personal taxes as much so that you don't increase corporate taxes as much. That is the most important change.

Then, second, beyond that, you know, I would like to see the base broadened even further. The House did not eliminate. They have eliminated the most abusive tax shelters, but there are still a fair number of them.

I am in favor of broadening the tax base as much as we can, and lowering rates as much as we can even though you don't get that much incentive effects. I think it makes the system fairer.

I think the House didn't go as far in that direction as the administration did. So I would like to see more of that.

But the major change has to be the shift in the tax burden from individuals to corporations.

Senator **CHAFEE**. Restate it again. The major shift has to be——

Dr. **CHIMERINE**. In my judgment, to make the bill more acceptable, you cannot cut taxes for individuals anywhere near as much as both proposals currently suggest.

Senator **CHAFEE**. Is the other side that you must do more about capital formation?

Dr. **CHIMERINE**. That's correct.

Senator **CHAFEE**. And if that were done, you would be for the bill?

Dr. **CHIMERINE**. Absolutely, compared with the current tax system. That doesn't mean you can't make some minor changes.

Senator **CHAFEE**. Dr. Brinner.

Dr. **BRINNER**. I would go even further. I think if I were forced to vote yea or nay on the bill as it stands, I would——

Senator **CHAFEE**. It is clear how you stand on that.

Dr. **BRINNER**. I would vote yea because I believe this committee within a year or two would rebalance it and fix the problems that exist. So I have already testified what fixes I would make if I were on this committee, and I stand by those.

Senator **CHAFEE**. Briefly reiterate them, could you?

Dr. **BRINNER**. Broaden the base on the personal tax by bringing back in half of State-local taxes, and some portion of employer-paid fringe benefits; use the $25, $30 billion that you would receive from that to fund a 5-percent across-the-board tax credit on nonresidential investments; and then move on.

Senator **CHAFEE**. All right. Dr. Schink.

Dr. **SCHINK**. I would want to move pretty much close to neutrality, a neutrality respect to both personal and corporate taxes, but not cut necessarily either, but to—at least not have the significant twist that is there now.

I very much am in favor of the notion of trying to implement minimum taxation for both corporations and persons. Whenever you start dealing with specific tax preference items in the law, there are all kinds of people who are, you know, who have reasons to defend them. And I think the minimum tax, while it is not an easy issue, unless you attacked the real problem and not get bogged down in the detail of what are the pluses and minuses of this particular tax preference item.

Senator **CHAFEE**. Changing course here a little bit, do you think the Tax Code should intervene on an industry-by-industry basis to stimulate investment in a particular industry? Should we have tax incentives for oil and gas or timber or mining or solar energy or should we just try to have the tax rate as low as possible across the board? Dr. Brinner.

Dr. **BRINNER**. In general, no; I don't believe industry specific intervention is called for.

Dr. **CHIMERINE**. Isn't your time up yet, Senator? [Laughter.]

Senator CHAFEE. That is what Senator Long said.

Dr. CHIMERINE. As little as possible.

Senator CHAFEE. As little as possible.

Dr. Schink?

Dr. SCHINK. I would agree with Dr. Chimerine, I think.

Senator CHAFEE. I couldn't hear you.

Dr. SCHINK. I would agree with Dr. Chimerine, I think.

The CHAIRMAN. As little as possible.

Senator CHAFEE. As little as possible.

Finally, you have had some dire predictions on the international competitiveness effects of this legislation. Yet how do you account for the fact that the people out in the real world, many of them big business—IBM and GM, for example—are for this legislation. Are they just off in the wilderness some place?

Dr. CHIMERINE. It would reduce their tax burden in most cases, I think. I can't specifically answer the question with respect to those three companies, but by and large many companies would see a reduction in their tax—their effective tax burden because they would benefit more from the reduction in tax rates, and they would lose from the elimination of the investment tax credit and rapid acceleration.

Senator CHAFEE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Dr. Brinner, let me thank you for your vote, and I am sure that the record will be utilized at the appropriate time. You have been asked today about the effect of the House bill on trade, jobs, international competitiveness, and interest rates, as if you were surgeons with scapel and could tell us precisely what was going to happen in all of these areas.

To give you the benefit of the doubt, these are broad informed guesses. Would you not concur? Yes or no?

Dr. CHIMERINE. I would like you to use the phrase "informed judgment."

Senator BRADLEY. All right, informed judgment.

Now on the question of trade, I think Senator Danforth asked you what will happen to trade, and you said that you thought that this would increase the trade deficit by about $10 billion. Was that Dr. Brinner who said that?

Dr. BRINNER. No.

Dr. CHIMERINE. I said that.

Senator BRADLEY. About $10 billion. And then Dr. Brinner said that that would be offset, and that the way you could offset that would be by a decline in the value of the dollar of about 5 percent. Is that correct?

Dr. BRINNER. Yes; that's correct.

Senator BRADLEY. And then Dr. Chimerine said that he thought it was advisable, in fact it would be extremely healthy, to get a decline in the value of the dollar. Is that not correct?

Dr. CHIMERINE. Yes; but not this way.

Senator BRADLEY. Not this way. But the point is you get a decline in the value of the dollar.

Dr. CHIMERINE. From current levels, without question.

Senator **Bradley**. Dr. Brinner then said that this would result in a drop in the living standards. Is that right? An equivalent drop in living standards?

Dr. **Brinner**. That's correct.

Senator **Bradley**. Now in the last 6 months we have had a 10-percent drop in the value of the dollar against the basket of currencies. Would you argue that we have had a 10-percent drop in the living standard in this country?

Dr. **Brinner**. We have had a 10-percent decline in our living standard relative to people in other nations because if we are all trying to buy the same international goods, we can buy 10 percent less than they could.

Senator **Bradley**. Right. Do you think that such a decline is a good idea? Are you glad we dropped to 10 percent against the basket of currencies?

Dr. **Brinner**. Yes.

Senator **Bradley**. You are?

Dr. **Brinner**. Yes.

Senator **Bradley**. Are you glad, Dr. Chimerine?

Dr. **Chimerine**. Absolutely.

Senator **Bradley**. Are you glad, Dr. Schink?

Dr. **Schink**. I am glad because of the reason it happened, yes.

Senator **Bradley**. All right. Do you think we should have a little more drop in the value of the dollar, Dr. Brinner?

Dr. **Brinner**. If it is brought about by deficit reduction.

Senator **Bradley**. All right, fine. Dr. Chimerine?

Dr. **Chimerine**. Yes; absolutely.

Senator **Bradley**. Dr. Schink?

Dr. **Schink**. Yes; I do.

Senator **Bradley**. And if we had a 5-percent drop in the value of the dollar it would totally offset the negative effect that you have applied to tax reform as regards the trade deficit.

Dr. **Brinner**. I would like to——

Senator **Bradley**. Now let me ask you another question.

Dr. Brinner, we agreed earlier that economic science is not precise, and you have implied since then that the testimony here has been based on predictions of investments. And, Dr. Brinner, you seem to draw a causal relationship between corporate tax burdens and investments. But it has been noted a couple of times today—and I think the record reflects this—that the corporate tax burden, as a percent of total income taxes, was much higher at different times. In the 1950's, it was 39 percent. In the 1960's, it was 34 percent. In 1975, the corporate tax burden was 25 percent. And what we are talking about under the two bills that you have testified about is a corporate burden of around 20 percent, which is 5 percent under where it was in 1975.

Now if you look at the 40-year period of the corporate tax burden, it has declined dramatically. And yet investment has not increased dramatically.

And I would also just like the record to reflect that on the theoretical level, wouldn't you be able to identify several economists that you might even know, and might even have a cup of coffee with sometime, who believe that investment is not determined so much by taxation and cost of capital as by demand and capacity utilization. And, therefore, my question to you. [Laughter.]

Senator **Bradley**. How precise, how sure can you really be when you are predicting investment levels down to the level of hundreds of millions of dollars in a $3 or $4 trillion economy? [Laughter.]

The **Chairman**. Time is up. [Laughter.]

Senator **Bradley**. They can answer the question.

The **Chairman**. They can answer. I'm not sure they can answer the question. [Laughter.]

Dr. **Brinner**. There is a simple answer to that. Economics is a science and all sciences perform experiments where they control one element, or they change one element and control all the others. And what our science does is to look at the separate impacts of all those items you mentioned—capacity utilization, the strength or demand, cash-flow, the presence of incentives, the level of interest rates—and we can tell you—definitely, we can tell you the direction, and we can give you a pretty good guess, a pretty good judgment about the quantitative magnitude of those changes.

The corporate tax burden as a share of total taxes is low today partially because the tax base is low. Corporate profits as a share of GNP are very low. The incentives are pretty strong from the tax side, but they are very weak from the cost-of-fund side.

We can filter all those things because we do have a science, and we can tell you that the tax changes that are being considered here are negative. We are not telling you that they couldn't be offset by more stimulative monetary policy or lower deficits.

Dr. **Chimerine**. Can I make a quick answer, Senator? I would say two things. First of all, there are a lot of other differences between the environment today and the 1950's and 1960's. We have much higher real interest rates. We are getting slaughtered in world markets. Our competitive condition has deteriorated dramatically. So I think you have to take those things in account in addition to just the tax burden has dropped over the—the corporate tax burden has dropped over the last 20 or 25 years.

With respect to your other point, I think I introduced my remarks earlier before you arrived with exactly your statement. And the truth of the matter is it is very, very difficult to make these kinds of judgments and calculations.

The best we can do is give you our best judgments as to what direction the effects are likely to be and whether those directions are desirable in the environment we are now in.

And, you know, I sincerely believe these changes will reduce investments somewhat from what it would have been. Will it mean an end to the world? No. We are talking perhaps modest changes. But nonetheless, that is the appropriate direction.

Dr. **Schink**. One of the things we have spent a lot of time worrying about is the relationship between incentive and investment. And I would agree that, in fact, rates of growth of output are probably the most important. Rates of growth of output are probably the most important determinant of levels of investment.

But the conclusions that we have reached are that all else being equal that investment will be lower, productivity will be lower, it will be less competitive internationally under the conditions, the Tax Code rules of this bill, than it would under current law.

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Senator Bradley. Assuming no change in deficit reduction or interest rates?

Dr. Schink. That's correct.

Dr. Brinner. Correct.

The Chairman. Senator Boren.

Senator Boren. Thank you, Mr. Chairman. I apologize. I was detained in another meeting and missed some of the earlier remarks, but I am delighted to see this panel focused on the problem of international competitiveness. There is no way that we can responsibly write a tax bill in a vacuum without considering what it does to our ability to compete with the rest of the world, save American jobs, and try to guarantee some kind of reasonable standard of living for our children and those that are going to come after us. So I am delighted you focused on it.

I have worried again and again that this may be a wonderful tax bill for Japan and a wonderful tax bill for the common market and our other competitors, but it worries me about what it is going to do to the United States. And so I am very glad to hear what you have said.

It is a tax increase bill, in my opinion; not a reform, because it is a tax increase of about $160 billion on saving, investment, and capital formation. An additional burden on the very things that we need to restore our competitive capability. I am a little intrigued by my colleague, Senator Bradley's, questions to you that we passed this bill and hurt our competitive position so much by doing so we if we could do some other things like get the value of the dollar down, some other things, to offset it, maybe it wouldn't be so damaging. Maybe we can undo some of the harm that we would do with this tax bill if we could get some other things done. Maybe we could get Japan to pass a similar tax bill to raise their own cost of capital. I would say to my good colleague that that might offset the damage of our passing this bill, too.

Let me ask this question: Since this will undoubtedly increase the cost of capital and hurt our competitive position, if you are going to lower individual rates as much as the House bill, and then in order to pay for that, if you are going to have a revenue-neutral bill, you can't make up that money that you are giving away with this hand. You know, we have learned you can't write tax cuts in red ink either any better than you can write spending in red ink and not finally wreck our economy.

So if we are going to give away $160 billion, we have to find a way to pay for it. The way we are paying for it now is tax, saving and investment; raise the $160 billion that way.

Senator Boren. Do you think there is any way that we could give away that $160 billion in reduced rates and still pay for it but raising what we might call business taxes without harming our competitive position? Or if we want to reduce rates that much and give away the $160 billion, to do that and remain revenue neutral and have a sound bill, it would not hurt us in terms of ability to compete with the rest of the world. Is it inevitable that we would have to look at some other revenue source to add to it? In other words, if we are going to do something back to encourage capital formation, and not raise taxes so much on capital formation but still give away $160 billion back to encourage further consumption in our society? Can we do that at all? Can we even consider doing that without looking at some other revenue source if that is where we start?

Dr. BRINNER. Well you certainly can consider other revenue sources to fund the investment incentives. I suspect that one that you will be considering, given the decline in oil prices, is some combination of gasoline taxes or an oil import fee.

The CHAIRMAN. I didn't hear the start of your answer. You said "we can consider other"——

Dr. BRINNER. We can.

The CHAIRMAN. And use them as an offset for the capital formation losses in the bill.

Dr. BRINNER. Yes; we can.

In my testimony, as I've noted, I show you the separate impacts of the personal tax cut and the corporate tax increase. And the real effective capital stock is initially higher because of the demand stimulus to invest.

The CHAIRMAN. Yes.

Dr. BRINNER. And then it eventually goes down from the personal tax cut.

Now if we consider oil taxes, in general I think that the price decline has been overdone, and it might depress some conservation that we need for the long run. And so I would favor something on the order of a gasoline tax. And if you need to balance it across the regions of this country, perhaps even include some kind of a tax on home heating fuels, because I believe the Joint Committee on Taxation has concluded that there is a combination of gasoline taxes and oil use taxes that turns out to be distributionally neutral across country, States where there is a lot of driving happen to be in the Sun Belt where there is not much heating, and vice versa.

An oil import tax though is not something that I would use as a dominant source of that revenue. I have three objections to that. One, it reduces our international competitiveness in energy intensive industries; two, it would certainly antagonize Mexico and the Arab States; and, three, it is a drain America first tax. It encourages us to produce today, drain our reserves; it accelerates the day that OPEC is back in the driver's seat.

Senator BOREN. The first part of your answer was excellent. [Laughter.]

Senator BOREN. I won't debate the other part now on this occasion.

Dr. CHIMERINE. Senator, to answer your question rather quickly; yes. If you can find a way—and there are only two choices, two ways of doing it—to reduce the burden on corporations from either the House or the administration bill by: First, reducing the cut in personal taxes by less, or, second, finding an alternative source of revenue. I think we have all stated several times that that would be a——

Senator BOREN. But in your opinion you have to do one or the other.

Dr. CHIMERINE. You have to do one or the other.

Senator BOREN. If you are going to give away as much in the individual rates and not duly harm our capital formation and cost of capital, you are going to have to find another source to do it.

How much—and it may be sort of falling along, and I know I am out of time—but if you could give a ballpark estimate, how much of this $160 billion tax increase on the saving of capital formation side would we have to reduce in order to keep this bill from being too damaging to our ability to compete in the world market? Is that figure half of it? Are we going to have to find, say, $80 billion from another source if we want to give away that much with the other hand? What kind of ballpark are we looking at?

Dr. **Chimerine**. The results are pretty linear, you know. If you tell me that you are going to move half of the personal package into the corporate side, I will tell you the business effects are half as bad.

Senator **Boren**. Uh huh.

Do the rest of you agree with that?

Dr. **Schink**. Just listening to this, I have a lot of problems with, you know, the sacred nature of the $160 billion giveaway to persons. That it would seem to me you could broaden the base and cut the rates without giving anywhere near as much away in the form of personal tax cuts and accomplish many of the objectives that are desirable as part of this package.

And I would concur, I think, that certain excise taxes such as an oil import tax might—would serve several purposes. But I think you really have to do the tradeoff, I think, more on the personal side than in looking elsewhere.

Dr. **Chimerine**. Senator, I would answer quickly that some increase in corporate tax is justified because you went a little too far in 1981, and there are some accounting abuses and other abuses. And our best calculations are that somewhere in the range of $50 or $60 billion can be justified. So I think your $160 billion——

Senator **Boren**. Right.

Dr. **Chimerine**. I am talking about reversing of $90 or $100 billion of the shift.

Senator **Boren**. So 50 or 60 you feel we could justifiably do. I have advocated a minimum tax for those who escape taxation completely.

Dr. **Chimerine**. In that range; yes.

Senator **Boren**. In that range. Thank you very much, Mr. Chairman.

The **Chairman**. How do you know where the magic point on the curve is?

Dr. **Brinner**. I don't think there is a magic point. As I said, I think it is pretty linear.

The **Chairman**. Well, let me go back.

All of you don't like this bill because there are immense shifts from individuals to business. Right? And you think that is unwise for the country. Senator Boren has suggested going back a bit. Dr. Chimerine says, well, maybe from 160 to 60.

Is the present law better than any shift at all? Or will we do better on capital formation and better on jobs if we hit business $50 or $60 billion dollars worth?

Dr. **Chimerine**. You are not going to do better than current law if you do $50 or $60 billion worth. Minimum tax provisions can be constructed to give you a pretty weak bang for the buck. That means that they won't reduce investments so much.

The **Chairman**. Let me reverse my question then.

Would we be better off to adopt some kind of broad-based consumption tax and use it as incentives for capital investment?

Dr. **Brinner**. Yes.

The **Chairman**. Dr. Chimerine?

Dr. **Chimerine**. I think so, yes.

The **Chairman**. Dr. Schink?

Dr. **Schink**. I would agree.

The **Chairman**. Now I am talking about, let's start from the present Tax Code, not the bill. And even from it you would adopt some kind of broad-based consumption tax and use the proceeds, partially perhaps for deficit reduction as I would judge what many of you have said, but anything we had left over use it to enhance incentives for capital formation.

Dr. **Brinner**. That's right. And target it toward the big bang for the buck incentive.

The **Chairman**. All right. Now what kind of consumption tax?

Dr. **Brinner**. The broader the base, the better so that you do not distort economic decisions. That is one of the objectives of tax reform.

The **Chairman**. Isn't a broad-based energy tax about as broad based as you can get?

Dr. **Brinner**. It is, except that it is on a narrow commodity; namely, just energy.

The **Chairman**. But it is passed through to everything we do.

Dr. **Brinner**. It is.

Right now one of the reasons that we can afford wages that are above international norms is because we have an advantage on energy costs relative to Japan. Our costs are about two-thirds of theirs. That allows us to pay a little bit more in wages. If we lose that energy cost advantage in producing goods then we can pay a lower wage.

The **Chairman**. So it isn't—let me move to Dr. Chimerine—it isn't just necessary to broad base. Indeed, energy is a broad tax. It is the form of the consumption tax in addition that you think is a factor, and it should not be one that increases the cost of doing business.

Dr. **Schink**. Right.

Dr. **Brinner**. That is correct. See, a value added tax increases the cost of the Japanese doing business here just as much as it increases our cost of doing business. So that doesn't hurt us. An energy tax just on domestic use hurts us.

The **Chairman**. Dr. Chimerine.

Dr. **Chimerine**. Mr. Chairman, I have no problem with a consumption tax, but I must say that I think a lot of people are expecting too much from one if we were to implement one. Again, there is no evidence that these consumption taxes really stimulate savings. Second, I am very worried about the distribution of income. The whole purpose of doing tax reform is to eliminate some of the inequities. We have shifted the burden of taxes in this country away from upper income groups toward others. The administration's program would go more in that direction. And potentially a consumption tax would even go more strongly in that direction.

The **Chairman**. Well, who——

Dr. **Chimerine**. We can solve our problem through the income tax structure if we want right now.

The **Chairman**. Well, if we are going to go not toward the House bill, but let's start with the present Tax Code and try to go toward some broader base—and you are going to use those receipts for deficit reduction and capital formation—what form of broader base?

Dr. **Chimerine**. My personal view is to reduce current exclusions from taxation, the tax expenditures, in some cases, the tax shelter activity, the deductions as much as we can, broaden the tax base on the income tax structure as much as we can, then lower the tax rates by an amount—it would still be lower than they are now—by an amount that would give us some net revenue increase. And we would have a broad-tax base. We would have a fairer tax system. We would have higher revenues, and at the same time use some of those revenues to limit the increased burden on the corporate sector.

The **Chairman**. Dr. Schink.

Dr. **Schink**. I would agree with broadening the tax base and reducing the rates. I go back to putting in strong minimum taxes on both the corporate and the personal side to do away with a lot of the abuses.

The **Chairman**. Now let me ask a second question in the bill as it comes from the House, because when you look at it it only has two basic features. One is the shift in the incidents of taxation. The other is a movement toward—although far from complete—an attempt to equalize taxes among business. That is not the shift, but among the business tax that you have.

And, Dr. Brinner, you said, yes, that is a good direction. And Dr. Chimerine and Dr. Schink said, well, as much as possible attempt to equalize them among business. Is that correct?

Dr. **Brinner**. Yes, sir.

The **Chairman**. Does that mean we should have as a nation no priorities among business? Steel is equal to avocados. And for whatever reason our steel industry declines or disappears, that is the cost of tax equality.

Dr. **Brinner**. Legitimate defense arguments should be addressed. Those arguments can be overblown. But I am not going to suggest that those are out of order.

The **Chairman**. Well I wasn't even thinking defense so much. I mean, if you go down defense, you have certainly got steel, you have got ship building. Senator Thurmond will say textiles. It is second only to steel in terms of importance. And right on down the line.

Indeed, the California avocado producers made an argument for national defense on avocados.

I want to go on down to Dr. Chimerine and Dr. Schink. Do we make no distinctions at all? Or if we do, what distinctions do we make?

Dr. **Chimerine**. Mr. Chairman, I think there are times you have to make distinctions whether it is for defense or if there is an energy crisis. There are times you should use the tax system to achieve certain economic or social objectives. I think we all will agree though we should agree we have gone way too far in that direction.

I cannot tell you right now exactly how far to cut it back or what situations constitute emergencies that can justify these kind of incentives. But I would agree, there are times when they are justified.

The **Chairman**. Dr. Schink.

Dr. **Schink**. I would concur and add that there are cases where our international competitors have, in fact, you know, offered a subsidy in one form or another to investment in certain industries. And if we aren't in some sense willing to offer our companies the same sort of benefits, they are going to lose out in the international arena.

The **Chairman**. Senator Mitchell.

Senator **Mitchell**. Thank you, Mr. Chairman.

We have all used a lot of different figures regarding the effects of the House bill and the President's bill. I think it is important that we understand the narrow nature of distinctions between those two bills, and in some respects between them and current law.

For example, the extent to which corporate taxes will be increased as a result of the House bill over 5 years according to the Joint Tax Committee is under—just under $139 billion. That is the Joint Tax Committee report.

The **Chairman**. Yes; that is the net. That is the figure I have been using too. The $160 or $160 billion was the gross on the change, but you had some tradeoffs where they pick up some money.

Senator **Mitchell**. That is right.

So in talking about the negative effects, the gross figure has been repeatedly used. And then, of course, you cannot take a bill and discuss only its negative and not its positive incentives.

The **Chairman**. No; the net figure is $140 billion, and that is still a shift of 140 from individuals to business.

Senator **Mitchell**. That is right. There is no question about it. But it is a lot less than 162, 168.

Second, also according to the Joint Tax Committee, the depreciation system proposed in the House bill is over a 5-year period, only $20 billion less generous for corporations than the current ACRS system. That is over a 5-year period.

Now you have emphasized this morning the importance of the investment tax credit. The point I would like to make is that if you exclude tha—and I understand that is a big exclusion—but if you exclude that—and that has been the direction of the discussions on this committee so far—the differences between the House bill and current law, according to the Joint Tax Committee, are relatively small. And I think that point ought to be made for the record.

Dr. **Brinner**. I can explain the differences.

The Joint Tax Committee I believe, like the—some of the analyses before—looks at the depreciation allowances given current rates and then credits the rate reduction with some other elements.

If you look at table 2 of my presentation you can see how important that is.

For example, the present value—just the depreciation allowances–only falls from 84 to 74 cents. And so you could value that, you know, at current tax rates. But the after-tax value falls by a much greater proportion, from 39 to 27 cents. So you have to decide are you going to give some credit to the tax rate change as part of the depreciation, or whatever? All these numbers jive. It is just the question of which ax you are trying to grind.

Senator **Mitchell**. And your answer points up precisely the point I made at the outset, it is that you are dealing with a very large number of variables over a long period of time, and making a highly speculative prediction that it is speculative is clearly demonstrated by the widely inaccurate predictions made in 1981 as against the current record.

Dr. Brinner, I have two things I would like to ask you about.

In response to an earlier question sometime ago you said that you estimated an increase in the cost of capital of about 5 percent as a result of the House bill. Can you tell me how much of your estimate is due to the change in the capital cost recovery allowances and how much, if any, would be due to a reduction in marginal tax rates?

Dr. **Brinner**. I testified the cost of funds would increase by a half point, and the total cost of using capital would increase by about 15 percent, not 5 percent. And I will have to create those numbers for you, but it is very easy.

Senator **Mitchell**. All right.

Dr. **Brinner**. Most of what we are discussing here in reference to the value of those depreciation allowances and rate changes is arithmetic. It is not prediction. There is not a debate here on that. This is purely arithmetic. And we would all come to the same conclusions on that.

Senator **Mitchell**. Oh, OK.

Dr. **Chimerine**. Senator, could I make a comment?

Senator **Mitchell**. Sure. Go ahead, Doctor.

Dr. **Chimerine**. Two things. I am just going to make the same point Roger did. That is arithmetic. The potential impact that that will have on capital formation, that is prediction.

Senator **Mitchell**. Right.

Dr. **Chimerine**. And that is where the difference can be.

Senator **Mitchell**. I understand that.

Dr. **Chimerine**. The other point, quite honestly, you talked about the projections that have been made in 1981 of how far off the market they were. I am not sure I agree with you completely on that, because I cannot talk for anybody else, but we predicted in 1981 that those marginal tax cuts would not stimulate savings; that we would have massive budget deficits for years to come; that the economy would not grow at 4 percent a year forever, or whatever.

If you really want to go back to 1981, the most serious mistakes were made in the forecast made by the administration. Yet you are citing their projections of the potential impact of tax reform in favor of the legislation.

I think if you are being honest and realistic, the truth of the matter is it is very hard to make these calculations. My own judgment is, as I said earlier, some of the effects might be much larger in the short run than in the long term. And that is what is going to surprise most of us. In the long term we will probably wind up where we were, or close to it, because you learn to adjust.

Senator **Mitchell**. Right.

Dr. **Chimerine**. My big concern is the potential large short-term transition effect.

Senator **Mitchell**. Well I think that is a very fair point Dr. Chimerine. I didn't make reference to your predictions.

I see my time is up again.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you, Mr. Chairman.

When you try to do tax reform it is a constant battle between equity, efficiency and, frankly, simplicity. I mean we turn to accountants to tell us about simplicity and listen to our constituents. We turn to economists to tell us about efficiency. And then ultimately we, as politicians, make the judgment about fairness.

Now you are here today telling us about efficiency. You have got about $400 billion worth of tax expenditures. Somebody has said to you, you have got to get the rates at 15, 25, and 35. So you know if you are going to get the rates there you have got to eliminate a certain percentage of those tax expenditures.

Now the House chose to do it one way. It took more from business than from personal. You are here today testifying on efficiency grounds; that that is not adviseable from the standpoint of the economy.

You also are here today saying that one way to change that would be to put a new tax on middle income people in order to pay for retaining some of the corporate loopholes.

Now it seems to me that that might be the efficiency argument, but I am not so sure that is the fairness argument.

Dr. **Chimerine**. Senator, I don't think we are saying that. I think what we are saying is not giving individuals the tax cut, or at least this much of the tax cut as is implied in either the administration's proposal or the House bill. Not to raise their taxes above current levels; just not make the additional cuts of that magnitude.

Senator **Bradley**. So you are saying close more loopholes.

Dr. **Brinner**. Close more loopholes. And also, you know, Joe Peckman from Brookings has commented on these bills, that just looking at the distributional impacts of the personal tax changes—and this is half of the story, because all those changes in corporate taxes affect some households eventually.

Senator **Bradley**. So if you had your choice would you close more loopholes or would you put a new tax in?

Dr. **Brinner**. Close more loopholes, broaden the base.

Senator **Bradley**. Dr. Chimerine?

Dr. **Chimerine**. Absolutely.

Senator **Bradley**. Dr. Schink?

Dr. **Schink**. I would also say that we probably don't endorse the sacred nature of the 25, 35 type rates. I mean you can cut rates and not come down that far and get something that way, and people will still enjoy some benefit.

Senator **Bradley**. But given a choice between a new tax and closing loopholes, you say close the loopholes.

Dr. **Schink**. Right.

Dr. **Chimerine**. Yes, sir.

Senator **Bradley**. Since we want to make a record here, I would like to ask you a question on housing. We have heard some comments about the House bill's affect on housing. And, Dr. Chimerine, you say in your testimony, "Construction spending is likely to slow despite lower interest rates because of significant building in recent years. In fact, already extremely high vacancy rates for office buildings are worst in many areas during the next 12 months as projects underway now reach completion."

It seems to me that what you are saying there—and you say it again at another point in your testimony—is that there is such a thing as quality of investment. And I wonder if you could comment about quality of investment, and how your models measure quality of investment as opposed to investment in pyramids, new plants and equipment?

Dr. **Chimerine**. Senator, you are raising what I think is an essential point, and this is what I have been trying to get at several times this morning.

In the short term for overall economic activity it doesn't matter whether the investment is good investment or bad investment. If they stopped building more empty office buildings or do whatever, and it depresses the level of economic activity in the short term, that will harm economic growth in the short run.

That is one of the reasons I think you have got to make the distinction between the short-term impact and the long term.

In the long term I am reasonably confident that a significant amount of the reduction in investment that we would see from this bill would tend to be inactivities which don't contribute much to productivity. And that is why I don't think we will get as much of a depressing effect on the economy as maybe my colleagues do. But in the short term you do because, you know, it is just a matter of common sense. It doesn't matter what you are cutting back on. If you cut back on, it is going to have a depressing effect on the economy.

I think on the long-term basis we adjust to that, and you do get some better efficiency. And on a net basis, the economy won't be too much worse off.

Dr. **Schink**. I think closing a loophole will in many ways do away with much of the so-called nonproductive investment where eliminating a tax credit or making the accelerated depreciation less accelerated, will, in fact, you know, cut across the board and be targeted at productive and nonproductive investment.

Senator **Bradley**. Dr. Brinner?

Dr. **Brinner**. The models do attempt to differentiate between investments that produce housing or produce drilling equipment and structures, and then they factor those in differentially into the productivity measures. So we try to take those into account as best we can.

Senator **Bradley**. But you do determine what is quality investment and what is not? Your model does?

Dr. **Brinner**. The models will not allow something stupid to go on forever. The vacancy rates, for example, are in there in the office building construction equasions. And if we put in a tax law that stimulates too much office building, that creates vacancies, and eventually there is an air pocket that causes that construction to fail. So, yes.

Stupid activities are not allowed to persist forever in a model.

Senator BRADLEY. Dr. Brinner doesn't agree.

Dr. CHIMERINE. To answer your question, Senator, it is very, very difficult to do.

The CHAIRMAN. Senator Boren.

Senator BOREN. Mr. Chairman, just on a different point but related to what you were talking about a while ago. If we have changes in tax policy, even if some of them end up being good changes, it is just the transition period can result in some slowdowns as the economy adjusts.

One of the things that we did recently informally was to say to our chairman that we felt it was very, very important that we try to make known as soon as possible that whatever bill, if we indeed pass a bill, would not be retroactive in effect; that it would not take effect on January 1, 1986, because here are people sitting out there now. It is past January 1, 1986. They don't know what the law is. We go around condemning the business community all the time. Why don't they make long-range investment decisions? And then we turn around and say, however, about every month we may change the rules of the game on you. So we create all this uncertainty.

Leaving aside the other questions, how important is it do you think that we very shortly make it known publicly and in a way that will give some ability to rely upon us that we will not pass a retroactive tax bill unless it is to expiring provisions or something like that? But that we will only have our product take effect after it has been enacted.

Dr. BRINNER. I think it is very important to such an extent that I didn't even run the stimulations, assuming that they take effect January 1. The footnotes indicate I assume they take effect January 1, 1987.

Dr. CHIMERINE. I think it would be both the smart and the fair thing to do, Senator.

Dr. SCHINK. I would agree.

Senator BOREN. Let me ask another question. The House, a procedural question, is they started to write their bill.

They started out by saying, here is how much money we are going to give away in terms of rate reduction. Now we have to come up with a list that adds up to that much money. That is a strange way to make tax policy, it seems to me. It doesn't really say what do we need to do; what's wise? You have to come up with, I think in this case, something like $240 billion total because we have given that much away in rate reduction.

It is sort of like saying, I am going out to take the credit card, charge it all up, and then I'm going to look for a job so I will have an income to pay the bill after I have already charged everything. Plus it puts you in a box. It forces you to take some things that may not be wise tax policy just because you have to come up with *x* amount of dollars.

I would assume from listening to you that in terms of writing sound tax policy you would think it would be very important that this committee follow the unique policy of saying, let's try to write a good tax bill, close the loopholes, see how many loopholes we can close on their own merits, and then see how much money we have. And then we will give away that amount of money. Instead of going from the reverse and saying, we will give away the money. Now we will put all this additional burden on, whether it makes sense from tax policy.

Dr. **Brinner**. I think your point is very apt.

You may have seen me doodling here, but there is no laughable curve drawn down here.

[Laughter.]

Dr. **Brinner**. There is nothing magic about a reduction from 50 to 35.

Dr. **Chimerine**. I would agree.

Dr. **Schink**. I agree that you should not start with any given number of reduction in personal taxes.

Senator **Boren**. Mr. Chairman, having heard such wise testimony, I have no further questions to ask.

The **Chairman**. I have got a couple more.

In response to the quality of taxation among business, each of you in one form or another said, well, but you may have to make some tilts on occasion. Maybe that is because of international competition and what your competitors do, or maybe you just decide that even internally in the United States some businesses are more critical than others. Is that a fair statement?

Dr. **Brinner**. Yes, sir; that is correct.

The **Chairman**. And if you make that decision, are you better off to use the Tax Code as an incentive or to go the direct appropriation route?

Dr. **Brinner**. I prefer the direct appropriation route. That keeps it right above board. In public vision, it is obvious what you are trying to accomplish and how much money you are spending there.

Dr. **Chimerine**. I would prefer the Tax Code.

Dr. **Schink**. I would prefer the Tax Code.

The **Chairman**. I think that is a very critical question, the difference between the Synfuels Corporation and the oil depletion allowance, if you want to put it on a broad basis. Or if you want to put it on another tax expenditure basis, assuming that the tax expenditure has been the inducement, it is the difference between Government appropriated national health insurance and basically employer-provided plans which exist because of a tax incentive.

I take it, Dr. Brinner, you are saying you would rather, if we are going to have some kind of national health coverage, you would rather have an appropriated Federal program than what we currently have.

Dr. **Brinner**. That is correct. And I think that the public finance literature supports that.

Stanley Surrey, when he was at the Treasury, and Richard Musgrave, his colleague from Harvard, used the phrase "tax expenditure" all the time. They are expenditures.

The **Chairman**. I understand they are.

Dr. **Brinner**. We just happened to total them up on the tax side rather——

The **Chairman**. I understand they are expenditures. The question is: Which way does the Government come out better, on the direct expenditure route or on the tax incentive route? And Dr. Surrey would say on the appropriated route. We should not do it by incentives.

Dr. **Brinner**. That is correct. And I would agree with that.

The **Chairman**. Dr. Schink.

Dr. **Schink**. There's always the offset or onset caveat there providing they administer it efficiently.

The **Chairman**. Well the Government programs are never administered efficiently.

Dr. **Schink**. So that is why I prefer the tax route.

The **Chairman**. I am often struck with how we win wars with Government-managed armies. Then I realize we are fighting other Government-managed armies.

Dr. **Brinner**. Let me clarify that. You can allow corporations to provide the health care plans and just pay them a certain amount of money for employees to be directed toward that. That is an expenditure. We don't have to have the Government manage the health program.

The **Chairman**. Let me go a step further then in terms of capital formation. Instead of investment tax credits and other forms of incentive, why not the equivalent of a gigantic reconstruction finance corporation and we will appropriate the money to the businesses because investment tax credits are tax expenditure?

Dr. **Brinner**. It is?

The **Chairman**. Why not then go the entire—why not go appropriations for everything?

Dr. **Brinner**. An investment tax credit is an appropriation that floats with the corporation's decisions.

The **Chairman**. Well the investment tax credit is a tax expenditure. We allow them—just like we do not require the payment of taxes on health insurance, we allow the deduction of the credit on the investment tax credit.

Wouldn't it be more efficient to have a government appropriation for those businesses?

Dr. **Brinner**. It wouldn't be more—it would be neither more nor less efficient if it provided the same incentive. If you told corporations there's a check in the mail on the way to you for 10 cents on every dollar you spend on producer's durable equipment, that ought to produce the same incentive as saying you can take 10 cents off——

The **Chairman**. But then we have got it above the board and we can see it.

Dr. **Brinner**. You have it above the board and you can see it. The expenditure rather than the tax credit is also available to firms regardless of whether because of the business cycle they happen to be losing money.

The **Chairman**. So you would prefer it to the tax credit?

Dr. **Brinner**. Yes; I would.

The **Chairman**. Dr. Chimerine.

Dr. **Chimerine**. I would prefer it on the tax incentive side myself for a number of reasons. One reason is I think it is easier to do it that way. You don't have to start putting checks in the mail. Second, there are a number of programs where if the Government gets involved on the expenditure side, fundamentally, as I think George mentioned a minute ago, you are likely to have more inefficiency because it won't be just a subsidy. It might, in fact, be a Government-financed activity. And in my judgment, we want to avoid as much of that as we can. We want to provide incentives to the private sector to do it through the tax side.

The **Chairman**. Dr. Schink.

Dr. **Schink**. I think the tax expenditure side, the investment tax credit rule lets the markets react to a signal you are giving it. You want more investment and it reacts. And I think that is a much better way I think of doing it. And it doesn't cancel out negative market signals, saying the return to investment isn't here, and so on. If you have no taxes to claim it against, maybe you should not do the investment.

The **Chairman**. And the three of you are a classic example of the split between Stanley Surrey's theory and mine. I prefer the tax incentive route if you are going to encourage something beyond the marketplace. If you want to say, well, let the marketplace work as it wants. And if that means that we have more commercial buildings and less homes, so be it. We have a policy that we want homes, and we allow people to deduct things and it is a tax expenditure. And I think that is a legitimate way to go about it.

Dr. **Chimerine**. I think, frankly, Mr. Chairman, the key issue is which activities we want to subsidize and provide incentives to.

The **Chairman**. Exactly.

Dr. **Chimerine**. And not which way we do it, quite frankly.

The **Chairman**. Exactly.

That ought to be the fundamental question first.

Dr. **Chimerine**. That's right.

The **Chairman**. Often you get tax expenditures who outlive their usefulness and they continue on.

Dr. **Chimerine**. Right.

The **Chairman**. When for whatever legitimate reason may have been when they were enacted 20 years later the legitimacy is gone, but they are still in the code.

Senator Bradley.

Senator **Bradley**. Mr. Chairman, I think that you have given perspective on your earlier question with the last comment, the question about Synfuels Corporation or depletion. The fact is we have eliminated the Synfuels Corporation. We haven't eliminated depletion.

It is always easier to eliminate an unwise program that is directly appropriated than it is to eliminate a tax expenditure that is lodged in the code and is never scrutinized.

Dr. **Brinner**. That is exactly the basis of it.

Senator **Bradley**. Would you agree?

Dr. **Brinner**. Yes.

Senator **Bradley**. One last question for the group. Although you have come out today with a rather clear point of view, I have found a number of interesting aspects of your testimony which show diversity in view and which could even be construed favorably by someone advocating the House position.

The question I want to ask is what, if any, business tax expenditures would you eliminate?

Dr. **Brinner**. I stated I would eliminate accelerated depreciation. It is capricious in its value to the corporation because it is so sensitive to expected future inflation, actual inflation and interest rates.

Senator **Bradley**. You would eliminate the whole thing?

Dr. **Brinner**. I think it is much better to do investment tax credits or to index the depreciation allowances to inflation than to——

Senator **Bradley**. So you would use pure economic depreciation or no depreciation?

Dr. **Brinner**. No. Of course, I would do economic depreciation and I would augment it with tax——

Senator **Bradley**. So for buildings it would be 40 years.

Dr. **Brinner**. That is correct.

The **Chairman**. And what did you say after that? You would do economic depreciation and what?

Dr. **Brinner**. And I would use tax credits. And if I also had the money to spend in the future, I would index those depreciation allowances.

Senator **Bradley**. So you would use a 40-year construction depreciation and go down to an economic depreciation for other categories of an investment tax credit. But is that the only business tax expenditure that you would eliminate?

Dr. **Brinner**. I always hestitate to say "only".

[Laughter.]

Senator **Bradley**. Dr. Chimerine.

Dr. **Chimerine**. I would do those too, Senator. But there are others and I am trying to think of some of them.

Dr. **Brinner**. The R&D tax credit I would support.

Senator **Bradley**. No, no. I don't want to know. I am taking from your testimony that you like the present code, the way it treats business. I am just curious. Are there any that you would eliminate?

Dr. **Chimerine**. I would go to an economic depreciation. Second, there were some other changes: Some of the accounting changes that benefit certain industries, you know, some of the tax shelter activity that is supporting some of the syndications that now are taking place. Tightening depreciation would eliminate a lot of that, but there are other changes that could be made.

Fundamentally, my concern is geared toward eliminating the abusive uses of tax shelters that reduce the tax burden. And I think changes in that direction are highly desirable.

Senator **Bradley**. Dr. Schink.

Dr. **Schink**. I think I would endorse going to economic depreciation and indexing the base. I mean, because that, in fact, corrects what you want to correct for, which is inflation. And I think of when we got ACRS many corporations were pushing for indexing, but it got killed.

I would agree with Dr. Chimerine that many of the tax shelter activities and tax abuse are what we ought to target. And I think the one way of keeping the incentive to invest and eliminating abuse is again the minimum tax. I am beginning to sound like a broken record, but I think that is the best way to go about it.

Senator **Bradley**. Which means that you buy the same political battles for trying to do a real minimum tax that you would buy if you try to implement tax reform.

Dr. **Brinner**. I would buy onto the political battle to reduce business entertainment deductibility too.

You said you wanted to know what I would eliminate?

Senator **Bradley**. Oh, that is what you would do.

Dr. **Brinner**. I would also eliminate some of that deductibility. I get the benefit from it, but I would eliminate it.

Senator **Bradley**. Be more specific. How much could I deduct for my lunch?

Dr. **Brinner**. $10 for breakfast, $15 for a lunch, $30 for dinner, per person.

Senator **Bradley**. That is the kind of certainty that I like. [Laughter.]

Thank you very much, Mr. Chairman. I thank the panel for their contribution today, and I think that their testimony on cost of capital; that is, that cost of capital is not only affected by taxes, but by interest rates, the value of the dollar, and several other factors, is quite helpful. And so if the committee realized that today—I know that we only have control over this one little lever that says "taxes"— but if we recognize that there are these other components I think this will be extremely helpful. And I think you brought that out today very clearly, and I thank you.

Dr. **Chimerine**. Senator, if I could make one last comment. It certainly is my view and I think my two colleagues here would share it. I think one of the things that we are saying as well as that, at least I would prefer the original Bradley-Gephart bill to either of the two currently under consideration, and that would be from every standpoint to make a dramatic improvement in the tax structure.

The **Chairman**. Can I ask one thing for the record? Do you prefer it because, at least principally—not solely but principally—because it has no shift of incidents of taxation from individuals to business?

Dr. **Chimerine**. Yes. And I also prefer it because it closes more of the tax loopholes than either, particularly the House proposal would.

Senator **Bradley**. Well I didn't ask for that, Mr. Chairman, but I appreciate it nonetheless.

The **Chairman**. Gentlemen, thank you very, very much.

[Whereupon, at 12:50 p.m., the hearing was recessed.]

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TAX REFORM ACT OF 1986

THURSDAY, JANUARY 30, 1986

U.S. Senate,
Committee on Finance,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Roth, Chafee, Heinz, Durenberger, Armstrong, Symms, Grassley, Long, Bentsen, Moynihan, Bradley, Mitchell, and Pryor.

The Chairman. Let me announce again for the benefit of the members who were not here before, we have in the audience today a delegation of about 30 international trade professionals and specialists from all over the world who have come to observe the testimony of the three witnesses that we have today. They are here under the auspices of the U.S. Information Agency. I have taken the opportunity to meet some of them, and welcome you here this morning.

We have three witnesses today: Dr. Alan Greenspan, Dr. Murray Weidenbaum, and Dr. Paul Craig Roberts. They are three economists all well known to this committee and who are not novices to testifying before this committee.

We had three economists yesterday testifying on the general effects of the tax bill. Today, this group is going to testify both on the general effects and especially how it may affect us in terms of international competition.

Unless the panel has any objections, we will take them in the order that they appear on the witness list, which would be Dr. Greenspan, Dr. Weidenbaum, and Dr. Roberts. And I would ask that you keep your comments to 10 minutes. Normally, we have said 5, but we wanted these to be long hearings, and yesterday with only three witnesses, we went about 3½ hours with the committee asking questions.

Part of the Republicans are missing today because there is a meeting at 9:15 about the trauma that is going to hit our offices because of Gramm-Rudman. We are all going to be cut 4.3 or 4.4 percent. I have a feeling somehow we will live with it and civilization will continue. But that meeting is going on right now as to whether it should come out of our mail allowances or staff allowances or travel allowances. And I think you will see a plethora of Republican Senators show up when that meeting terminates.

Any opening comments?

[No response.]

The **Chairman**. If not, Alan, we are delighted to have you start. Dr. Greenspan.

STATEMENT OF DR. ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO. INC., NEW YORK, NY

Dr. **Greenspan**. Thank you very much, Mr. Chairman.

I must say I do forecast that the Senate and its staff and its operations will probably remain pretty much intact. At least I think so.

Maybe somebody will come up and sequester the Senate or something.

The tax reform bill passed by the House of Representatives, if enacted, would create significant changes in the structure of the American economy. In principle, I favor, as do most economists, the elimination of tax subsidies and a lowering of marginal rates for both individuals and corporations. The House bill, however, will create such significant changes in the structure of incentives and underlying values of properties that it may engender shocks to the system which are not absorbed readily.

For the individual Tax Code, I would have preferred a lesser rise in the personal exemption and a decline and not a rise in the capital gains tax rates. Nonetheless, the individual tax changes considered as a package are desirable. The major problem, of course, is that the revenue lost in improving the individual revenue code creates a major problem for the business sector. It, in fact, creates risks which I suspect are larger than we should be willing to take.

The argument for converting the investment tax credit and for shortening depreciation schedules into corporate taxe cuts are reasonably straightforward. A much sounder economy is likely to result as a consequence of a shift away from tax subsidies. Unsubsidized capital investment is, on the margin, likely to be significantly more productive than investment which has to be subsidized through tax preferences. There is a close correlation between the pretax earnings generated from a facility and its degree of productiveness. In fact, the real rate of return on a facility tends to be determined largely by improved labor productivity and/or increased capacity. If all investment were made on the basis of pretax earnings, with depreciation reflecting true economic wear and tear, then capital would be directed toward those investments which have the highest marginal productivity.

An investment whose pretax rate of return is otherwise too low can become desirable for an individual company, of course, if lower taxes boost its after-tax rate of return. The investment tax credit, for example, is an effective means of inducing business to invest in capital equipment when the equipment fails to meet the test of pretax rate of return on an unsubsidized basis. If a pretax rate of return is above the cost of capital, investments will be made with or without the ITC. Even investments which are initiated solely because of the investment tax credit, however, usually create some increase in productivity or capacity. The issue generally is that they produce less than projects which meet the required cost of capital and in the long run, investment which does not earn the cost of capital on a pretax basis is a misuse of resources and a potential undercutting of economic growth.

The only valid argument for a continuation of tax subsidization is that the cost of capital is inordinately high on a temporary basis and subsidies merely roughly simulate the market conditions which would exist under more normal cost of capital situations. I would tend to concur in the argument. Only if the budget deficit can be brought down, and long-term interest rates and capital costs fall as a consequence, does eliminating the ITC and accelerated depreciation make economic sense. To remove tax subsidies on capital investment when capital costs are abonormally, and, hopefully, temporarily high, threatens growth in our standards of living. Hence, even though I would not like to see the issues of tax reform and budget deficit reduction intertwined, they are nonetheless economically inseparable in my judgment.

We know that once the cost of capital returns to normal, removing tax subsidies from the capital investment process will improve the efficiency of the economy and ultimately the level of output in the long run. The evaluation of short-term impacts, however, are more difficult. The number and magnitude of the changes in the House-proposed tax bill are too great to be evaluated easily by our existing macroeconomic models. Macromodels can effectively evaluate only changes made at the margin; that is, small tax changes and/or small expenditure changes. Policy innovations which create abrupt changes in the incentive structure, which the House bill would surely do, present far more difficult analytical problems. By design, macromodels endeavor to reflect the near-term implications of the most recent past. The immediate future under this proposed new tax regime, however, would be substantially different from the economic and mathematical conditions upon which these models are based. That will make it difficult to get anything but a judgment of gross impact. Matching pluses and minuses suggests that the short-term impact of the tax bill on the economy would be at least mildly negative. It is difficult to be more precise since this tax bill will have to deal not only with changes in cash-flows, changes in after-tax incomes, and changes in incentives created by the new rate structure and broadened tax base, but also with the very substantial changes in the market value of assets which would occur following passage of the bill.

Just as farm subsidies are capitalized in the market value of farm land, so are tax subsidies capitalized in the value of all forms of properties. In this sense, real estate market values are higher than they would otherwise be without the tax preferences currently in the code, and their removal eventually will bring down the value of real estate relative to other assets. For example, commercial real estate construction is likely to be impacted more negatively than one would assume based strictly on the change in the prospective cash-flows and rates of return under the new prospective tax regime.

The expectation of declining property values could, for a while, produce a pullback in activity even greater than the cash-flows themselves would suggest. There also may be some modest upward pressure on commercial and residential rents, although new owners coming in at lower property values, and hence less equity requirements, would enjoy a benefit which partially offset the loss of tax benefits and would, hence, limit the upward pressure on rents.

The major adverse impact of the tax bill is likely to be in the manufacturing industries which already have been depressed significantly by high interest rates and the strong dollar. The average increase in corporate taxation under the House bill is far greater for these groups, which depend heavily on the investment tax credit, than for the more service-related or high-tech industries. Effective tax rates for many companies would rise rather substantially. These include companies which have purchased, through safe harbor leasing provisions, tax credits to lower their effective tax rates, as well as companies with low pretax operating earnings and large capital investments.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared written statement of Dr. Greenspan follows:]

Excerpts from the Testimony of Alan Greenspan*
Before
The Committee on Finance
United States Senate
January 30, 1986

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The tax reform bill passed by the House of Representatives, if enacted, would create significant changes in the structure of the American economy. In principle I favor, as do most economists, the elimination of tax subsidies and a lowering of marginal rates for both individuals and corporations. The House bill, however, will create such significant changes in the structure of incentives and underlying values of properties that it may engender shocks to the system which are not absorbed readily.

For the individual tax code, I would have preferred a lesser rise in the personal exemption and a decline and not a rise in the capital gains tax rates. Nonetheless, the individual tax changes considered as a package are desirable. The major problem, of course, is that the revenue lost in improving the individual revenue code creates a major problem for the business sector. It, in fact, creates risks which I suspect, for ~~reasons I will explain below~~, are larger than we should be willing to take.

The argument for converting the investment tax credit (I.T.C.) and foreshortened depreciation schedules into corporate tax cuts are

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(This material is intended solely for the confidential use of our clients)

reasonably straightforward. A much sounder economy is likely to result as a consequence of a shift away from tax subsidies. Unsubsidized capital investment is, on the margin, likely to be significantly more productive than investment which has to be subsidized through tax preferences. There is a close correlation between the pretax earnings generated from a facility and its degree of productiveness. In fact, the real rate of return on a facility tends to be determined largely by improved labor productivity and/or increased capacity. If all investments were made on the basis of pretax earnings, with depreciation reflecting true economic wear and tear, then capital would be directed toward those investments which have the highest marginal productivity.

An investment whose pretax rate of return is otherwise too low can become desirable for an individual company, of course, if lower taxes boost its after-tax rate of return. The investment tax credit, for example, is an effective means of inducing business to invest in capital equipment when that equipment fails to meet the test of pretax rate of return on an unsubsidized basis. If a pretax rate of return is above the cost of capital, investments will be made with or without the I.T.C. Even investments which are initiated solely because of the investment tax credit, however, usually create some increase in productivity or capacity. The issue generally is that they produce less than projects which meet the required cost of capital and in the long run, investment which does not earn the cost of capital on a pretax basis is a misuse of resources and a potential undercutting of economic growth.

The only ~~current~~ valid argument for a continuation of tax subsidization is that the cost of capital is inordinately high on a temporary basis and subsidies merely roughly simulate the market conditions which would exist under more normal cost of capital situations. I would tend to concur ~~with that~~ IN THE argument. Only if the budget deficit can be brought down, and long-term interest rates and capital costs fall as a consequence, does eliminating the I.T.C. and accelerated depreciation make economic sense. To remove tax subsidies on capital investment when capital costs are abnormally, and hopefully, temporarily high, threatens growth in our standards of living. Hence, even though I would not like to see the issues of tax reform and budget deficit reduction intertwined, they are nonetheless economically inseparable in my judgment.

Even if we eventually eliminate tax preferences on investments, the playing field is still less than level owing to accounting conventions of longstanding. While the House bill endeavors to move depreciation charges into a more realistic relationship with true economic lives, as best these can be estimated, it must be remembered that there are, nonetheless, many quasi-capital investments which always have been expensed and, indeed, still are expensed. We write off capital investment over a series of years on the grounds that such investments produce income over a comparable time period. This is also true, however, for many expensed outlays such as research and development, institutional advertising, work force training, etc. The crucial question is whether the particular expenditure is directed at immediate earnings or future earnings. Obviously, expensing is appropriate as a charge against those activities which are endeavoring to produce profit immediately. In principal, write-offs should match the timing of the profit producing characteristics of the activity. In this regard, there is no fundamental difference between a brick-and-mortar facility, which lasts fifteen years, and research and development activities which produce a product and profit over the same time frame. Institutional advertising and work force training clearly have much of the same characteristics. Many companies which report high effective corporate tax rates do so not because their taxes are high, but because the reported pretax profits are low, owing to the expensing of a large number of activities which are directed toward the production of future income. Many companies have low reported implicit tax rates because their expensing relative to their depreciation charges is low.

We know that once the cost of capital returns to normal, removing tax subsidies from the capital investment process will improve the efficiency of the economy and ultimately the level of output in the long run. The evaluation of short-term impacts, however, are more difficult. The number and magnitude of the changes in the House proposed tax bill are too great to be evaluated easily by our existing macroeconomic models. Macromodels can effectively evaluate only changes made at the margin, that is, small tax changes and/or small expenditure changes. Policy innovations which create abrupt changes in the incentive structure, which the House bill would surely do, present far more difficult analytical problems. By design, macromodels endeavor to reflect the near-term implications of the most recent past. The immediate future under this proposed new tax regime, however, would be substantially different from the economic and mathematical conditions upon which these models are based. That will make it difficult to get anything but a judgment of gross impact. Matching pluses and minuses suggests that the short-term impact of the tax bill on the economy would be at least mildly negative. It's difficult to be more precise since [redacted] this tax bill we have to deal not only with changes in cash flows, changes in after-tax incomes, and changes in incentives created by the new rate structure and broadened tax base, but also with the very substantial changes in the market value of assets which would occur following passage of the bill.

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The major adverse impact of the tax bill is likely to be in manufacturing industries which already have been depressed significantly by high interest rates and the strong dollar. The average increase in corporate taxation under the House bill is far greater for these groups, which depend heavily on the investment tax credit, than for the more service related or high tech industries. Effective tax rates for many companies would rise rather substantially. These include companies which have purchased, through safe harbor leasing provisions, tax credits to lower their effective tax rates, as well as companies with low pretax operating earnings and large capital investments.

STATEMENT OF DR. MURRAY WEIDENBAUM, DIRECTOR, CENTER FOR STUDY OF AMERICAN BUSINESS, WASHINGTON UNIVERSITY, ST. LOUIS, MO

The **Chairman**. Dr. Weidenbaum.

Dr. **Weidenbaum**. Thank you, Mr. Chairman, and members of the committee. It is good to be before the Senate Finance Committee once again, and I hope you find my statement of some interest.

I have been quoted as saying that if all the economists in the world were laid end to end it would be a good thing. It is sad to say the tax reform debate so far provides a case in point.

Here we are discussing and defending the esoteric merits of a more pristine tax structure which would make absolutely no contribution to the urgent problem of the budget deficit, the trade deficit, and debt problems, rural, domestic and foreign. In fact, when I examine the specifics of the tax reform proposals facing this committee today, I find they would worsen those severe national problems.

The **Chairman**. You realize, of course, the genesis of this is Treasury I, which was drawn up by economists.

Dr. **Weidenbaum**. Indeed, and I think that underscores my opening gambit. [Laughter.]

Dr. **Weidenbaum**. That was many years after I left the Treasury.

The **Chairman**. Of course, I understand that. [Laughter.]

Dr. **Weidenbaum**. Moreover, H.R. 3838 and all its kissing cousins really do not constitute tax reform. I will provide support for these strong statements.

First of all, true tax reform would have started the other way with revisions of the Tax Code and then offsetting changes in the rate tables to maintain revenue neutrality when so much of today's serious debate is on how much you cut specific rates. Clearly, the driving force in the House bill and in all the Treasury proposals is another round of income tax cuts.

We all like to pay lower taxes, and I would pay lower taxes under the House bill. But tax cuts are not now the urgent need of this country.

Moreover, H.R. 3838 and various Treasury versions all focus on the politically vulnerable sections of the code in order to maintain a semblance of revenue neutrality. So many of the proposed changes would reduce saving and investment. That means the total package is not economically neutral. It would get us a lower GNP and higher unemployment, and, hence, lower revenues, higher social spending and a bigger budget deficit. It would also hit hard many of the industries already hardest hit by foreign competition.

Unlike the old saying, H.R. 3838 does hit a man and a woman when they are down. As for the claim of simplicity, the bill violates any truth in labeling law. Many tax returns will become more complicated. I think that is clear from any reading of the bill.

And I thank the committee staff for sending me the entire bill. That was quite an education.

Just consider those new distinctions between different categories of taxpayers and the proposed expansion of accrual accounting. Certainly anyone who has been exposed at least to a semester of undergraduate accounting cannot view accrual accounting as a move toward simplicity.

And as for fairness, why should people with fluctuating incomes pay more taxes than people with stable incomes. That will be the result of eliminating income averaging.

Why should the capital gains tax on timber depend on whether your business is incorporated or not?

Why is the tax exemption of the college professors' retirement fund rescinded, but not those of unions, companies, and fraternal organizations?

And to hit home, why should tax credits for political contributions be deleted except for congressional races? [Laughter.]

Dr. WEIDENBAUM. And that is not all. Since submitting my formal statement, I have prepared a list of 67 special benefits put in H.R. 3838, and I have submitted them to the committee staff. To avoid designating all those special benefits by name, the bill describes those doozies in terms such as a "paint and glass project which was approved by the management committee of a company on September 11, 1985." Now that is a blow for tax reform. [Laughter.]

Dr. WEIDENBAUM. Here is another: "Rental property which was assigned FHA No. 02336602." That is really neat. It is not special purpose legislation because the benefit covers every taxpayer whose FHA number happens to be 02336602.

Of the 67 items, my favorite is a project which was "the subject of lawsuits filed on June 22, 1984 and November 21, 1985." Now that is really beautiful. Getting sued now qualifies you for a special tax benefit.

Oh, yes, the bill also includes a new expenditure subsidy for the Olympics. Just think about it. Enacting another uncontrollable back-door spending program is part of tax reform.

I would like to end on a positive note. I urge the committee and the Congress to follow a new two-level approach. The first and more visible is the focus on the overriding priority facing our country and the Congress, and that is cutting Federal spending to bring the deficit down. That is a tall order.

And the Finance Committee, with its wide jurisdiction over entitlements, has a vital role to play. Simultaneously, and while that main act is going on, at the staff level, Treasury and committee staffs should do a really comprehensive analysis of the specific provisions of the Internal Revenue Code. And they need to identify those that generate more costs in terms of revenues lost than benefits in terms of public policy served.

It would not be a matter of ideology to label all of those tax expenditures as derogatory. It would be a hardnosed, openminded review. I would guess—I do not want to prejudice the analysis. I would guess that many housing shelters might flunk the benefit-cost test because the loss to the Treasury might exceed the new funds going into housing. But the ITC might well pass the test.

You do not know until you do it.

But let me sum up very quickly. Right now, the cart is before the horse. I urge the committee to put the horse of budget cutting before the cart of tax reform.

Thank you.

The CHAIRMAN. Thank you.

[The prepared written statement of Dr. Weidenbaum follows:]

TAX REFORM: WHEN AND HOW

by Murray L. Weidenbaum

Testimony prepared for the Senate Finance Committee,
Washington, D.C., January 30, 1986

My position here today is a clear case of role reversal. In analyzing Treasury I, Treasury II and the House tax bill, I find the government taking too academic a position and this professor urging more attention to reality. Specifically, when I rank the most serious problems facing our country right now, tax reform doesn't even make the list.

We can all readily agree that the current tax structure is full of well-known shortcomings. But, by and large, producers, consumers, and investors have adjusted to those shortcomings. Debating tax reform has introduced considerable uncertainty over the treatment of saving and investment. This uncertainty has a chilling effect on investment planning. Far more important than tax reform is dealing with the budget deficit, the trade deficit, and the pervasive debt problems -- rural and urban, foreign and domestic.

Back in the classroom, it is challenging and useful to identify a more equitable and efficient tax structure for the long run. We can hope that such analyses will help to improve tax policy over the years. But in the context of today's pressing concerns, focusing on tax reform is not only irrelevant; it is

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Note: Dr. Weidenbaum is Mallinckrodt Distinguished University Professor and Director of the Center for the Study of American Business at Washington University in St. Louis. The views he expresses are strictly personal.

counterproductive. Debating tax reform now shifts attention away from the hard but compelling challenge of controlling federal spending.

Each of the recent versions of tax reform, including the House bill, would dampen saving and investment and, thus, economic growth -- just as the economy is slowing down. A smaller GNP means less revenue into the Treasury. It also means more federal spending for unemployment compensation, food stamps, and welfare. All of this adds up to bigger budget deficits.

The House bill would make it more difficult for American firms to compete, even as international competition is becoming more fierce. The numerous blows to saving, investment and R&D would slow down the modernization of American plants.

Corporate taxes would be raised by about $140 billion over the next four years, further straining our ability to compete. Many of the companies hardest hit by imports -- those in capital-intensive heavy industry -- would have their tax burdens increased most substantially. This is an unusual switch from the old proposition that you don't kick a man when he's down.

The proposed changes in bank taxation would come at a time when those institutions are wrestling with the difficult debt problems of the private sector. For example, deductions for bad-debt reserves are eliminated, except for relatively small banks. Finally, the claim of tax simplification violates any truth-in-labeling law.

Here is some support for these statements:

I. **The claim that the House bill is revenue neutral does not hold up.** Projections of future federal revenues are based on overly optimistic estimates of economic growth. For example, the assumed 4 percent growth rate in 1986 compares with the prevailing private-sector forecast of 3 percent. In a $4 trillion economy, a 1 percent difference implies a substantially smaller tax base and lower revenue collections.

II. **That shortfall in revenue is compounded by the proposed shift of the tax burden from consumption to investment.** Many provisions of the House tax bill would discourage saving and investment:

1. The dividend exclusion is eliminated.

2. The top capital gains rate for individuals is raised from 20 percent to 22 percent.

3. The cap on annual contributions to 401K contractual employee retirement plans is reduced from $30,000 to $7,000 -- and the employee in effect is also prevented from making an IRA contribution.

4. The incremental R & D credit is reduced from 25 percent to 20 percent and extended for only three years -- when analyses show that the temporary nature of the credit reduces its effectiveness.

My colleagues Laurence Meyer, Joel Prakken and Chris Varvares have estimated that, by 1991, the House tax bill would result in a level of GNP 2.3 percentage points lower than under present law and unemployment 1.1 percentage points higher.

In the process, we see a political perpetual motion machine at work. That is, the institution of the investment tax credit and of liberalized depreciation were originally hailed as tax reform. Reversing policy on these investment incentives is now justified as tax reform.

III. **The claim of tax simplification is a bad joke.** The proposed distinctions between different categories of individual taxpayers and also between different categories of corporate taxpayers surely make it likely that tax returns will be more complicated in the future.

Whatever its other merits, requiring expanded use of accrual accounting cannot be viewed as simplification, not by anyone who has been exposed to at least a semester of undergraduate accounting. Of course, this is only forced upon certain businesses, not others -- a further complication. And the host of transition rules, albeit an inevitable accompaniment to a package of far-reaching tax changes, make for further complexity.

IV. **The claim of fairness is overblown.** I fail to see the equity in eliminating income averaging. Why should people with fluctuating incomes pay more taxes than people with stable incomes? Why should the capital gains tax on timber sales depend on whether your business is incorporated? Why is the tax exemption of the college professors retirement fund rescinded, but not those of unions, companies, and fraternal organizations? Why does the effort to toughen the tax treatment of three-martini lunches and lavish entertainment also expand to the most modest non-alcoholic business breakfast meeting? Why should corporations who want to establish and expand markets overseas be forced to pay an additional tax on their overseas earnings? Why should tax credits for political contributions be deleted -- except for Congressional elections?

V. **The label of tax reform is misleading.** The driving force in the House bill -- as in Treasury I and Treasury II -- is another round of income tax rate reductions. Given the goal of revenue neutrality, this means identifying the most politically vulnerable provisions of the Internal Revenue Code so that they can be changed to yield offsetting revenues.

True tax reform would move in the opposite direction. It would start with the desired changes in the tax structure, and then adjust the rate tables -- in whichever direction is necessary -- to maintain revenue neutrality.

What Should Congress Do Now?

Tax reform and deficit reduction are both important and desirable objectives. The choice in 1986 is a matter of putting first things first. As the most elementary analysis of national priorities shows, that means elevating budgetary control to the top of Congress' policy agenda. That is not a task for just the budget and appropriations committees. Virtually every committee of the Congress has jurisdiction over federal spending programs. That certainly is true of the Senate Finance Committee, with its broad jurisdiction in the key area of entitlements.

I suggest that Congress think in terms of a two-track approach. While the budget-cutting drive is accelerating, more moderately paced tax reform studies should be getting under way. Specifically, committee and Treasury staffs should undertake a careful review of the structure of the Internal Revenue Code. Drawing on the good work that they have done in the last several years in identifying special tax provisions, they should now evaluate each of them by weighing the cost (in terms of revenue foregone) and benefits (in terms of public policy objectives achieved).

Where the studies reveal that the revenue loss exceeds the funds going into the end activity -- such as in many shelters that finance housing -- the conclusion would be clear: change or even eliminate the provision. But, in other cases, where the benefits (say, in terms of more capital investment and hence enhanced international competitiveness) are greater than the revenue loss, the provision would be continued.

These tax choices would be based primarily on effectiveness rather than ideology. To state categorically that all "tax expenditures" are undesirable is foolish. Some may be a more effective and less expensive substitute for direct federal spending.

The time-consuming and comprehensive tax review I am proposing should take place while Congress and the President concentrate on the many difficult problems involved in cutting expenditures. In that manner, they can get on the path that leads to achieving the deficit reduction targets in Gramm-Rudman-Hollings prior to making basic changes in the tax system.

The result would be an effective one-two punch strategy -- instead of two wild and unsatisfactory swings that seem to be in store for us under the current procedure. The first punch at the nation's economic problems would be spending cuts and deficit reduction. That would set up the economy for the second punch -- tax reform. To state the matter a little differently, it is up to the Senate to put the horse of spending control before the cart of tax reform.

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January 30, 1986

SOME SPECIALLY DESIGNATED BENEFICIARIES UNDER HR 3838, THE HOUSE-PASSED TAX REFORM BILL

Despite the claims of fairness and simplicity, the House-passed tax reform bill goes out of its way to designate numerous recipients of very specific benefits. To avoid or minimize mentioning their names, HR 3838 provides restrictive descriptions that often border on the comical.

Here are some of the specific projects and organizations that qualify for special treatment under the bill, together with the page on which it is contained:

1. An urban renovation project where "a political subdivision" granted the development rights on July 11, 1985, provided that the project was the subject of a development agreement between a political subdivision" and "a bridge authority" on December 19, 1984 (pp. 136-7).

2. A dragline which was acquired in connection with a three stage program which began in 1980 to increase production from a coal mine, provided that (a) at least $35 million was spent before September 26, 1985 on the first two stages and (b) at least $4 million was spent to prepare the mine site for the dragline (p. 140).

3. A project being carried out by a corporation engaged in the production of paint and glass provided that (a) the project involves a paint filling line (at least $1 million of which was incurred before September 26, 1985), (b) the project is a turbogenerator which was approved by the president of such corporation, (c) at least $1 million of cost was incurred before September 26, 1985, (d) the project is a waste-to-energy disposal system which was approved by the management committee of the corporation on March 25, 1982, (e) the project includes an applications building, service facility, conference center, and refinishing school, (f) the construction was approved by the management committee of the corporation on September 11, 1985, and (g) the project is a facility to consolidate the silica production of the corporation at Lake Charles project (pp. 141-2).

4. Any part of a sewage treatment facility, provided (a) a city-parish advertised in September 1985 for bids for construction of secondary treatment, (b) in May 1985 the city-parish received statements from 16 firms interested in privatizing the waste water treatment facilities,

(c) the metropolitan council selected a privatizer at its meeting on November 20, 1985 and (d) adopted a resolution authorizing the Mayor to enter into "contractual negotiation" with the selected privatizer (pp. 147-8).

5. A university founded in 1789, where the obligations are issued pursuant to an application filed on August 5, 1983 or April 30, 1985 with the governing body of the issuing jurisdiction and requests to issue such obligation were transmitted to Congress on November 7, 1985 (p. 648).

6. A parking facility for a university medical school, provided that (a) the last parcel of land for it was purchased on February 4, 1985 and (b) the amount of obligations to be issued for it was increased by the state legislature as part of its 1983-84 general appropriations act (p. 661).

7. A residential rental property project, provided that (a) an urban development action grant application for it was submitted on September 13, 1984, (b) a zoning commission map amendment was granted on July 17, 1985 and (c) the number assigned to such project by the Federal Housing Administration is 023-36602 (p. 667).

8. A residential rental property project, provided that (a) an inducement resolution for it was adopted by the state housing development authority on January 18, 1985 and (b) the project was the subject of law suits filed on June 22, 1984 and November 21, 1985 (p. 667).

9. Perhaps the widest departure from tax reform is the new subsidy established for the U.S. Olympic Committee. The outlay is to equal the amount of taxes collected on U.S. broadcasting rights for Olympic events, less administrative costs (pp. 1030-1).

* * *

The following are 58 other special tax benefits that HR 3838 would provide:

10. An urban renovation project where a "development agreement" was entered into during April 1984 and the estimated cost is approximately $191 million (p. 137).

11. An urban renovation project where a "development agreement" was entered into during May 1984 and the estimated cost is approximately $177 million (p. 137).

12. An urban renovation project where a "development agreement" was entered into during September 1983 and the estimated cost is approximately $107 million (p. 137).

13. An urban development project with an estimated cost of approximately $92 million and at least $7 million was spent on it before September 26, 1985 (p. 138).

14. An urban development project with an estimated cost of approximately $40 million and for which at least $2 million of construction cost was incurred before September 26, 1985 (p. 138).

15. An urban development project where a "development agreement" was entered into before September 26, 1985 and the estimated cost is approximately $120 million (p. 138).

16. A project involving a fiber optic network of at least 20,000 miles, provided that (a) construction was begun before September 26, 1985 and (b) at least $85 million was spent on it (pp. 140-1).

17. A project which is part of a flat rolled product modernization plan which was initially presented to the board of directors of the taxpayer on July 8, 1983, provided that (a) such program will be carried out at three locations and (b) it will involve a total estimated minimum capital cost of at least $250 million (p. 141).

18. A project which involves a port terminal and oil pipeline extending generally from the area of Los Angeles, California, to the area of Midland, Texas, provided that, before September 26, 1985, there is a binding constraint for dredging and channeling and a management contract with a construction manager (pp. 142-3).

19. A newspaper printing and distribution plant which, on January 8, 1985, entered into a contract for the purchase of eight printing press units and related equipment to be installed in a single press line, the contract price for which represents at least one-half of the project cost (p. 143).

20. A project for which a letter of intent was executed on June 4, 1985 and a 5 percent down payment was made for two ten-unit press lines and related equipment (pp. 143-4).

21. A project which is the second phase of a project involving direct current transmission lines spanning approximately 190 miles from the Canadian border to Ayer, Massachusetts, alternating current transmission lines from Ayer to Millbury to West Medway, Massachusetts, and DC-AC converter terminals in Monroe, New Hampshire, and Ayer, Massachusetts (p. 144).

22. A natural gas pipeline for which three applications for construction were filed with the Federal Energy Regulatory Commission before November 22, 1985, provided that two were filed before September 26, 1985 and the pipeline is between 350 and 400 miles long and one of its terminal points is near Bakersfield, California (p. 144).

23. The tri-cities solid waste recovery project involving Fremont, Newark, and Union, California (p. 146).

24. The multi-family housing at the Columbia Point Project in Boston, Massachusetts (p. 146).

25. A binding contract entered into on October 20, 1984 for the purchase of six semi-submersible drilling units at a cost of $425 million (p. 146).

26. Any part of a cogeneration facility, provided that (a) an "inducement resolution" was adopted on September 10, 1985, (b) the development authority was given an inducement date of September 10, 1985 for a loan not to exceed $80 million for the project, and (c) the facility is expected to have a capacity of approximately 30 megawatts of electric power and 70,000 pounds of steam an hour (p. 147).

27. A corporation the stock of which is acquired pursuant to a plan of divestiture which was agreed to by the board of directors of the parent corporation on May 17, 1985 (p. 309).

28. A merger which occurs pursuant to a merger agreement entered into before September 24, 1985, provided that an application for approval by the Federal Home Loan Bank Board was filed on October 4, 1985 (p. 309).

29. A reorganization involving a group of corporations engaged in enhanced oil recovery operations in California, that were merged under a reorganization plan adopted by a board of directors on September 24, 1985 and a Delaware corporation whose principal oil and gas producing fields are located in California (p. 309).

30. The conversion to a stock association of a mutual savings and loan association holding a federal charter dated March 22, 1985 (p. 310).

31. A dock or wharf for which the financing issue was approved by official city action on September 3, 1985 and by voters on November 5, 1985, provided it is for a slack water harbor with respect to which the Corps of Engineers had made a grant of approximately $2 million (p. 642).

32. A dock or wharf where the "inducement" resolutions were adopted on May 23, 1985, September 19, 1985, and September 24, 1985, provided that (a) a harbor dredging contract was entered into on August 2, 1985 and (b) a construction management and joint venture agreement was entered into on October 1, 1984 (p. 643).

33. A facility for which "inducement" resolutions were adopted on September 23, 1974 and April 5, 1985, provided that (a) a board resolution was adopted on September 6, 1985 and (b) the issuance of the bonds was delayed by action of the Securities and Exchange Commission (file number 70-7127) (pp. 643-4).

34. A facility for which there was an inducement resolution on November 19, 1985 and design and engineering studies were completed in March 1985 (p. 644).

35. A domed stadium which was the subject of a city ordinance passed on September 23, 1985, for which a loan of approximately $4 million for land acquisition was approved on October 28, 1985 by the state Controlling Board and a stadium operating corporation incorporated on March 20, 1985 (p. 645).

36. A stadium for which a lease agreement on the ground was entered into between a county and the stadium corporation on July 3, 1984, provided that (a) on November 14, 1984 a resolution was approved by an industrial development authority setting forth the terms under which the bonds to finance the stadium would be issued and (b) an agreement for consultant and engineering services was entered into on September 28, 1984 (pp. 645-6).

37. A stadium to be used by an American League baseball team currently using a stadium in a city having a population in excess of 2,500,000, provided the obligations to finance the stadium are issued under an inducement resolution adopted by a state agency on November 20, 1985 (p. 646).

38. A stadium or sports arena for Memphis, Tennessee, provided that (1) an inducement resolution was adopted on November 12, 1985 to issue the obligations and (2) the city council adopted a resolution on April 19, 1983 to include funds in the capital budget for the facility (p. 647).

39. A baseball stadium located in Hudson County, New Jersey, for which "governmental action" occurred on November 7, 1985 (p. 647).

40. A university established on April 21, 1831, for a project approved by its trustees on September 23, 1985 and the purposes "for which such obligations are to be issued" were approved by the appropriate state authority on September 26, 1985 (p. 649).

41. A university established on August 6, 1872, for a project approved by the trustees on November 11, 1985 (p. 649).

42. A university for which the founding grant was signed on November 11, 1885, and the obligation is issued to provide a Near West Campus Development Project and a Graduate Student Housing Project (p. 649).

43. A mid-field airport terminal and accompanying facilities at a major air carrier airport which during April 1980 opened a new precision instrument approach runway 10R28L (p. 650).

44. A project which was the subject of a city ordinance numbered 82-115 and adopted on December 2, 1982 or numbered 9590 and adopted on April 6, 1983 (p. 651).

45. A redevelopment project for an area which was designated as commercially blighted on November 14, 1975 by the city council provided that the redevelopment plan for it will be approved by the city council before July 1, 1986 (p. 651).

46. A redevelopment project for an area which was designated as commercially blighted on May 25, 1976 by the city council and the redevelopment plan for it will be approved by the city council before July 1, 1986 (p. 651).

47. A redevelopment project for an area which was designated as commercially blighted on March 28, 1979 by the city council and the redevelopment plan for it was approved by the city council on June 20, 1984 (p. 652).

48. A redevelopment project for an area which was designated as commercially blighted on September 7, 1985 by the city council and the redevelopment plan for it will be approved by the city council before July 1, 1986 (p. 652).

49. A convention facility for which an application for a state loan was approved by the city council on March 4, 1985 and the city council approved on March 20, 1985 an application for an urban development action grant (pp. 653-4).

50. A convention facility for which a convention development tax took effect on November 1, 1983, provided that (a) the state Supreme Court validated such tax on February 8, 1985 and (b) an agreement was entered into on November 14, 1985 between the city and county in which the facility will be located regarding the terms of the obligations to be issued to finance the facility (p. 654).

51. A convention facility for San Jose, California, which was intially approved in 1983 (p. 654).

52. Meeting rooms for a convention center, provided that resolutions and ordinances were adopted with respect to such meeting rooms on January 17, 1983, July 11, 1983, December 17, 1984, and September 23, 1985 (p. 655).

53. A convention facility for which a resolution expressing intent to issue bonds was adopted on September 27, 1985, provided that (a) a resolution designating the site for the facility was adopted on August 9, 1985 and (b) an agreement for concession services was entered into on July 16, 1983 (p. 655).

54. A state admitted to the Union on November 16, 1907 for refunding not more than $186 million of state turnpike obligations (p. 656).

55. A hospital incorporated on April 24, 1925 and opened on May 9, 1927 (pp. 656-7).

56. Two hospitals which were merged, providing that (a) a contract was entered into before December 1, 1985 to sell property of one of the hospitals to provide equity funds for the merger and (b) a certificate of need was applied for with the state health commissioner during September 1983 (p. 657).

57. A dock or wharf which the legislature first authorized on June 29, 1981, provided that (a) the developer was selected on April 26, 1985 and (b) an inducement resolution for the bonds was adopted on October 9, 1985 (p. 658.

58. A dock or wharf for which an inducement resolution was adopted on October 17, 1985, and the city council approved on July 30, 1985 an application for an urban development action grant for the facility (p. 659).

59. A local district heating or cooling facility for which the feasibility and design work was completed on October 10, 1985, provided that (a) a preliminary inducement resolution was adopted on November 6, 1985 and (b) the authority to enter into long-term electric purchase agreement was granted on September 13, 1985 (pp. 659-660).

60. A local district heating or cooling facility for which requests for proposals were made before April 13, 1984, provided that it was approved by a county legislature before December 5, 1985.

61. A parking facility for which an inducement resolution was made on March 9, 1984, provided that on January 31, 1984 an application was submitted for an urban development action grant for it (pp. 660-1).

62. A sewage facility serving Los Onos, California (p. 661).

63. The California Student Loan Finance Corporation, to refund qualified scholarship funding bonds (p. 662.)

64. The Volunteer State Student Assistance Corporation, for its qualified student loan bonds (p. 663).

65. The purchase of electric capacity on an intertie line, provided that (a) the authority making the purchase was formed on May 19, 1985, (b) was granted the authority to make the purchase on October 22, 1985, and (c) the amount of capacity to be purchased is approximately 33 megawatts (p. 664).

66. A solid waste disposal facility, provided that (a) its construction was approved by state law I.C. 36-9031, (b) there was an inducement resolution on November 19, 1984 for its obligations, and (c) a carry forward election of unused 1984 volume cap was made for such project on February 25, 1985 (p. 666).

67. The Rhode Island Housing and Mortgage Finance Corporation, for refunding of bond anticipation notes issued in December 1984 which mature in December 1986 (p. 667).

STATEMENT OF DR. PAUL CRAIG ROBERTS, WILLIAM E. SIMON PROFESSOR OF POLITICAL ECONOMY, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY, WASHINGTON, DC

The CHAIRMAN. Dr. Roberts.

Dr. ROBERTS. Mr. Chairman, members of the committee.

My colleagues and I at the Institute for Political Economy have spent considerable time analyzing the impact of H.R. 3838. We will shortly be publishing a report giving a detailed analysis of the impact of this bill. I would like to give you a summary report this morning.

We cannot find any sector of the economy that would be helped by this bill. It would raise the cost of corporate capital, thereby undermining our competitive position. It would raise the cost of noncorporate capital. It would especially hit the trade sector of the economy.

There are tables in the back of my testimony which show the impact of the bill on the cost of capital by provision, by asset class, by industry class. There are other tables showing what the personal tax rate reduction comes to. And there are tables showing the impact on the cost of capital in the export and import sectors. And, finally, there is a table showing the relative comparison of the cost of capital in the United States with our major trading partners.

This bill has other features which indicate also that it was not well crafted. For example, about one-third of the gain in revenues that this bill provides by taxing the business sector, it is about one-third of the revenues used to cut the personal taxes, comes from a retroactive tax on inventories. And this will, I think, cause a great deal of unhappiness among constituents when they have to go back through and revalue inventories that they already have on the shelf and adjust their tax positions.

This bill also continues what I think is a deplorable curtailment of private pension systems that began in 1982. The increased revenues that are estimated to result from this curtailment of private pensions will not materialize because this bill would, by curtailing pensions, reduce the savings rate, and, thereby, reduce the capital stock and, thereby, the growth of wages such that you would lose rather than gain revenues.

And, finally, in summary, I might say that the static estimates of revenue to be gained from the expanded minimum tax are unlikely to be realized. Previous revenue estimates of similar changes have always been larger than the final receipts.

For example, in 1969 when the first minimum tax was put into place, it raised a little over $100 million from individuals. And the original estimate was $440 million.

TEFRA raised only half of the estimated $600 million that the minimum tax was supposed to bring in from individuals in 1983. And that, of course, ignores the much larger loss of income and payroll taxes which resulted from the sharp decline in the mining sector caused by the impact of TEFRA on profits.

The minimum tax is not an income tax. It is a tax on the use of various provisions in the Tax Code. In the case of tax avoidance, shelters simply reorganize or cease and no revenues are forthcoming.

In other cases, the minimum tax could be triggered as a result of a firm experiencing difficulties, such that its profits drop relative to its so-called preferences, in which case a firm experiencing difficulties could be thrown into the minimum tax which would then contribute to its problems.

I might say also that section 6 of this bill, or title 6, the tax on foreign source income, most likely contains provisions which would also reduce the competitive position of U.S. firms in markets at home and abroad.

Finally, though it is not part of the bill, it has been put on the table, the notion that by denying deductions for State and local taxes that you could raise a certain amount of revenues. This is not likely to happen. If you deny the current deductions, most likely State and local governments would experience pressure to rely more on deductible business taxes. They would simply change their behavior, and, therefore, instead of a revenue gain, you could end up with a revenue loss relative to current law because businesses would take the deductions at a higher average marginal tax rate than individuals.

So trying to improve the bill by denying State and local tax deductions would probably add to the deficit.

The proponents of H.R. 3838 have not sat down and tried to figure out what is the impact of this bill; what does it do to the economy; what does it do to various sectors of the economy. In that sense, no homework has been done on this bill. It is irresponsible to make a massive revision in tax law without a very thorough analysis of what you expect to be the result.

As far as I can tell, the reason that this work was not done is there does not seem to be any real purpose for this bill. In the minds of the people who drafted it, what were they trying to achieve; what is their purpose; what is their goal. It is very difficult to see what that is. And, therefore, you have sort of a random, haphazard piece of work which would substantially contribute to the serious trade problems that we already experience.

I do not think the bill is revenue neutral. Because of its adverse economic effects, it would be in dynamic terms a revenue loser, and I doubt that it is even revenue neutral in the static sense.

So, Mr. Chairman, I would say that if you are going to take up tax reform, unless you want to seriously hurt the trade sector, and the economy overall, unless you want to have retroactive taxes on inventories, unless you want to continue curtailing the private pension system and people's financial independence in retirement—unless you want to do all those things, if you want to do tax reform, it seems to me you are going to have to start over from scratch.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, doctor.

[The prepared written statement of Dr. Roberts and answers to Senator Symms questions follows:]

Questions from Senator Symms for Paul Craig Roberts

1. In your testimony, you noted that the present tax code is a critical factor in increasing the cost of capital in the U.S. H.R. 3838 would only serve to make matters worse. In what ways should the present system be reformed?

2. You expressed the opinion in your testimony that the Finance Committee should "start from scratch" in considering tax reform legislation. Does the Hall-Rabushka proposal, as you understand it, meet the tax reform criteria you set out in your answer to Question 1, especailly as to its effect on U.S. international competitiveness and, if not, in what ways should it be modified?

Paul Craig Roberts
Answers to questions submitted by Senator Symms for record of January 30, 1986 Finance Committee Testimony.

1. The most important reform that needs to be made of the U.S. tax code is to eliminate the tax bias against saving that results from the multiple taxation of income from saving and investment. This bias is a source of the relatively high cost of capital in the U.S. which results in lower saving and investment rates and slower productivity and GNP growth rates. The U.S. tax code is the main cause of the growing inability of U.S. produced goods to compete in markets at home and abroad.

In order for the U.S. economy to achieve its potential best performance, it is necessary to replace the income tax with an expenditure tax, or to adopt an expenditure-based income tax. It is critical that tax rates on income be low and preferably flat if income is taxed.

2. The Hall-Rabushka proposal would be an improvement over H.R. 3838, over the Administration's proposal, and over current law. Expensing of business investment and a low flat tax rate would improve the competitive position of U.S. goods. I would also exempt saving from the tax base on the personal side of the code.

The U.S. was most successful in absorbing large numbers of poor immigrants and simultaneously reducing the percentage of the population in poverty at a time when there was no income taxation. Income redistribution and dropping the poor off the tax roles is not the most effective way to improve the long-term position of people who are currently poor.

The Remarks
of
Paul Craig Roberts

William E. Simon Chair
in
Political Economy
Center for Strategic and International Studies
Georgetown University

Chairman
The Institute for Political Economy

Before

Committee on Finance
United States Senate

January 30, 1986

Introduction

Mr. Chairman, members of the Committee, my colleagues and I at The Institute for Political Economy have examined the impact of H.R. 3838.[1] We find it would raise the cost of capital and reduce our ability to compete. Overall, H.R. 3838 would raise the cost of corporate capital by 3.3 percent. It would raise the cost of noncorporate capital by 13.6 percent. The export sector of the U.S. economy would be particularly hard hit.

Other provisions of the bill lead to the conclusion that it is not a well-crafted piece of work. For example, the proposed changes in accounting rules impose a retroactive tax on business inventories already on the shelf that account for about one-third of the total revenue gains needed to pay for the personal tax reductions.

As this Committee is aware, I am an advocate of tax reform. However, H.R. 3838 does not meet any known definition of tax reform, much less one that would improve the competitive position of the U.S. economy in markets at home and abroad. What we have here, it seems, is a bill that serves no purpose other than a shallow political one of changing some tax provisions and calling it reform. It is an exercise in pretense. The bill would obviously make the code more complex. Some people think the bill would improve fairness--and it would for foreigners by making

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[1] Brazell, David, Robbins, Aldona, Robbins, Gary, and Roberts, Paul Craig, The House Tax Bill: Would the U.S. Win or Lose?, The Institute for Political Economy and The Krieble Foundation, Forthcoming 1986.

U.S. products even less competitive. Others think the bill is a reform because it lowers tax rates, but other provisions more than offset this positive aspect. If there is going to be a real tax reform that helps rather than hurts the economy, this Committee is going to have to start over from the beginning.

H.R. 3838 and the Cost of Capital

The personal and corporate tax rate reductions and dividend deduction in H.R. 3838 would contribute to a lower cost of capital and improved economic performance. These beneficial changes, however, are not sufficiently large to offset other provisions in the bill that work to raise the cost of capital. As Table I-a shows, the loss of the investment tax credit and ACRS depreciation more than offset these positive features of the bill. The corporate, noncorporate, and trade sectors would be burdened with a permanently higher cost of capital.

A greater reduction in income tax rates or a larger dividend deduction could be used to prevent these rises in the cost of capital. However, considering the requirement of static revenue neutrality and the revenues required to greatly expand the personal exemption, it would be difficult to find the revenues for a larger tax rate reduction within the confine of the bill.

The basic problem with H.R. 3838 is that it raises marginal tax rates on new investment and uses the proceeds to lower the average tax rate on labor income and on investments already in place. Consequently, the bill raises taxes in a way that severely impedes incentives and lowers taxes in a way that fails to capitalize on the full incentive effect. In terms of pro-growth incentives, H.R. 3838 worsens rather than improves the tax code.

Impact by Selected Provision

Tables I-a through I-c reveal the differential impact of selected provisions in H.R. 3838. The data in the tables are measures of the cost of capital, that is, the gross return required on a dollar's worth of new capital so that all of the investment's associated costs, including taxes, depreciation, and a normal rate of return, are covered. The first row in Table I-a shows the corporate cost of capital by asset category under present law. The second row measures the cost of capital when the pension provisions of H.R. 3838 are imposed. The third row shows the cost of capital when, in addition to the pension changes, the changes in accounting rules are included. The last five rows include successively the removal of the investment tax credit (ITC), replacement of ACRS depreciation with H.R. 3838's "Incentive Depreciation System", the corporate rate reduction, the personal rate reduction, and the full 1996 dividend deduction and changes to inter-corporate dividends received.

The incremental impact of the provisions applied successively, beginning with the pension provisions, is shown in Table I-b.[2] Cumulative impacts are given in Table I-c.

Loss of the ITC has the largest impact on the cost of capital. It would increase the cost of equipment by 16.2 percent, the cost of structures by 4.2 percent, and nonresidential fixed investment by 11.2 percent.[3] Loss of ACRS would further increase the cost of nonresidential fixed capital by 6.3 percent, with the largest increases occurring for structures. Thus, the two provisions in H.R. 3838 that specifically affect the tax treatment for new investment would raise the cost of capital by 17.5 percent. The increase is slightly higher for equipment.

The increase in the cost of capital resulting from the removal of the ITC and the change in depreciation is only partially offset by the corporate and personal tax rate reductions. The drop in the average marginal corporate tax rate from 46 percent to 36 percent offsets 6 percentage points of the increase and the drop in the average marginal personal dividend tax rate offsets another 7 percentage points. The fully phased-in 10 percent dividend deduction at the corporate level, scheduled to take effect in 1996, would offset another 1.3 percentage points. The effect of the dividend deduction provisions are partially offset by the accompanying changes in the treatment of intercorporate dividends. Thus, overall H.R. 3838 raises the cost of nonresidential fixed investment by 4.7 percent without the 1996 deduction and by 3.3 percent with that deduction.[4]

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[2] The selected tax provisions enter into the cost of capital calculations in a nonlinear fashion. The incremental change attributable to each provision, therefore, differs according to the order in which each is applied. The estimates in Table I nevertheless provide a reasonable idea of the relative importance of the selected provisions.

[3] The definition of structures used in the tabular material is from the U.S. Commerce Department. Commerce defines structures as anything produced by the construction industry. While buildings are generally not allowed an investment tax credit, most other structures do qualify.

The pension changes represent the most distressing example of short-sighted policy. One major feature of the pension provisions would limit employees accumulation of retirement funds through their employer. The Joint Committee revenue estimates assume that the disallowed deferred compensation would instead be paid out as taxable wages, which with other changes result in a revenue increase of $34 billion over the next ten years.

The economic effect of the loss of the pension reserves has been overlooked. The stock of capital would be $40 billion lower at the end of ten years, and the taxes lost due to lower wages of employees working with less capital would be greater than the estimated revenue gains. This provision will lose revenue in the long run under even the most favorable economic assumptions.

The most unusual of the categories in this table is the change in the accounting rules. These changes account for a

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[4] The specific assumptions concerning tax rates, discount rates, and investment provisions for present law and H.R. 3838 are contained in The House Tax Bill: Would the U.S. Win or Lose?.

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modest 1.3 percent increase in the service price of the assets listed in Table I-b. However, they account for almost a 20 percent change for inventories. This provision accounts for about one-third of the business tax revenue gain used to reduce personal taxes. What is less obvious is the fact that nearly two-thirds of the revenue from the provision comes from a retroactive feature. Every firm will be forced to revalue its current inventories under the new set of accounting rules. This revaluation has no time limit; it applies to all inventories, regardless of when they were put in place.

Tables II-1a through II-4b contain estimates of the change in the service price due to H.R. 3838 classified by broad asset type and industry sectors for corporate and noncorporate capital. All industries are worse off, but the manufacturing industries are hardest hit. The cost of capital in the noncorporate sector is hit much harder since it does not benefit from the corporate rate reduction or the dividend deduction provisions.

The Effect of H.R. 3838 on Individual Taxes

Marginal tax rates on labor income and returns from investments influence decisions to work and save. Thus, part of the economic impact of H.R. 3838 is measured by comparing the average marginal tax rates on wages and salaries and dividends under H.R. 3838 to those under current law.

The major changes in individual taxes are reductions in the statutory rates, including a reduction in the top rate from 50 percent to 38 percent; a reduction in the number of brackets; and a doubling of the personal exemption for non-itemizers and a 50 percent increase for itemizers. These changes will impact all categories of individual income. The estimates of average marginal tax rates by type of income that followed were prepared using 1983 data on individual income tax returns.

Tables III-1 and III-2 contain the weighted average marginal tax rate for five income items under current law and H.R. 3838 for 1987 and 1996. The average marginal tax rates are shown for all taxpayers with each type of income and within each quintile of adjusted gross income (AGI).[5]

The marginal tax rate on wages and salaries is comprised of the marginal Federal income tax rate plus the employee social security tax rate. Under current law the marginal tax rate on wages will be 33.1 percent in 1987 and rise to 36.6 percent by 1996. Under H.R. 3838 the average marginal tax rate on wages and salaries is reduced to 30.1 percent in 1987 and would rise to 32.9 percent by 1996. Thus, the effect of H.R. 3838 would be to reduce the average marginal tax rate on wages and salaries by 9.9 percent in 1987 and by 11.2 percent in 1996.

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[5] The first quintile refers to the lowest 20 percent of wage earners by AGI; the second quintile to the next 20 percent of wage earners by AGI; and so forth. See The House Tax Bill: Would the U.S. Win or Lose? for the data on the quintile classes.

The marginal tax rate on the second quintile class (between $5,000 and $11,000 in 1983), however, would actually increase from 23 percent under current law to 25 percent under H.R. 3838. As incomes grow over time, taxpayers in the second quintile will find themselves increasingly in the 15 percent and 25 percent brackets under H.R. 3838. Under current law the rate on the first bracket is only 11 percent and there are several intermediate steps before the 25 percent bracket is reached.

The next item combines the marginal federal income tax rate on wages and salaries with the employee and employer social security tax rate. This marginal rate gives a truer representation of how labor compensation is affected. H.R. 3838 would reduce the marginal tax rate on labor compensation by 7.3 percent in 1987 and by 8.5 percent in 1996.

The marginal rate on dividend income under current law using 1983 data is much higher than what was previously estimated by Treasury using 1981 data.[6] By 1996 the rate under current law would be 38.1 percent versus 31.6 percent under H.R. 3838 -- a 20.6 percent reduction. Comparison of 1981 and 1983 income distributions shows that there has been a shift in dividends received toward the upper income taxpayers. The cumulative distributions are lower for each AGI class from under $20,000 to between $100,000 and $1,000,000. The 1983 SOI data support the

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[6] Treasury estimates the marginal personal tax rate on dividends to be 32.7 percent under current law. See The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May, 1985, p. 158.

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supply-side hypothesis that the reduction in the top marginal rate from 70 percent to 50 percent in The Economic Recovery Tax Act of 1981 would induce upper income taxpayers to earn more taxable income.

More dividend income is now distributed at higher AGI classes which are taxed at higher marginal rates. Lowering the top marginal rate from 50 to 38 percent, therefore, has a greater impact on the average marginal tax rate for the 1983 distribution than for the 1981 distribution.

The remaining items show the change in marginal tax rates on interest received, interest paid, and nonfarm business income. The change in the marginal tax rates on other components of personal income follow the same pattern as those for dividends and wages and salaries. The largest cuts are at either income class extremes. For most income items, marginal tax rates fall by about two to three percentage points overall, much less than that implied by the 12 percentage point drop in the top marginal rate.

The marginal rates on the second quintile, however, rise while the marginal tax rates on all other quintiles fall. This group also bears a greater burden of the redistribution from young to old via the social security tax and transfer system. H.R. 3838 would further impede the ability of lower income persons to keep more of the fruits of their labor.

Pension Changes

H.R. 3838 continues the retrenchment against private pensions begun with the Tax Equity and Fiscal Responsibility Act of 1982. TEFRA reduced the maximum defined benefit that could be funded from $136,425 to $90,000 and the maximum amount to be put in a defined-contribution plan from $45,000 to $30,000. The stated purpose of this change was to prevent the subsidization of pension benefits to higher paid employees.

H.R. 3838 would further reduce these limits from $90,000 to $77,000 and from $30,000 to $25,000. In addition, the defined-contribution limit would be frozen until the defined-benefit limit reaches $100,000.[7] If inflation continues at 4 percent a year, the defined contribution limit would not be increased until sometime around 1993. In the meantime, the pension benefits of more and more workers would be eroded.

The economic effect of the pension changes in H.R. 3838 is to raise the tax on savings. We estimate using the Joint Committee on Taxation revenue estimates, that an average of $7 billion more a year in labor compensation would be paid out as taxable wages and salaries over the next ten years under H.R. 3838. If this occurs, each dollar previously going directly into a pension plan will be paid to the worker who actually receives

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[7] Prior to TEFRA the limits received annual cost-of-living adjustments. Currently, the limits are frozen until 1988 when they are to receive post-1986 COLAs.

$0.65 after-tax.[8] If the workers decides to save the $.65, each dollar of dividend income will be taxed at 36 percent and each dollar of interest income will be taxed at 34 percent(See Table III). The marginal tax rate on investment income from a private pension plan is zero until the worker retires or withdraws his accumulated assets. Comparing the zero tax rate on labor compensation that is put in a private pension with the 60 percent double tax rate on labor compensation first taxed as wages and then taxed again as non-pension savings, the worker will save less under H.R. 3838 than current law.

Lowering the limits on funding for private pensions reduces the amounts going into private pension assets and therefore reduces savings necessary for capital formation. Depending upon the administrative and regulatory burdens imposed by complex tax provisions on private pensions, the reduction in private pension assets may be even greater than expected. Instead of lowering the pension benefits of highly paid workers, the benefits of lower and middle income workers may be lost if qualified plans are abandoned in favor of unfunded, non-qualified plans.[9] Retirement income security for workers of the baby boom generation will be reduced at the very time it should be strengthened. Furthermore, the ability of the United States to maintain, let alone increase, the capital stock that will be needed to support a population whose average age is increasing will also be hampered.

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[8] Workers earning $35,000 and above will be affected by the pension limit changes. The marginal tax rate on the highest quintile worker in 1996 is 36.9 percent (see Table I-1a).

[9] A non-qualified plan is not subject to the provisions of the Employee Retirement and Income Security Act (ERISA) which include funding and nondiscrimination requirements. Contributions to non-qualified plans made by the employer on behalf of an employee are considered current income to the employee and taxable as such.

International Trade and H.R. 3838

Of key concern is what will happen to the competitive position of the United States in world markets if H.R. 3838 becomes law. The economic impact of H.R. 3838 would be to raise the overall cost of production. Any increase in the cost of U.S. production naturally reduces the ability of U.S. firms and industries to compete domestically and abroad.

The provisions of H.R. 3838 would clearly hurt the export sector. Table IV compares the overall change in the cost of corporate and noncorporate capital with the impact on the export and import industries.[10] The cost of capital in the trade sector would be raised by more than the overall cost of capital. For example, in 1986 the cost of corporate capital in the export sector would be raised by 29 percent more than capital overall. By 1996 this difference would rise to 53 percent. The relatively greater increase in the cost of production in the trade sectors would hurt the competitive position of U.S. firms in domestic and foreign markets.

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[10] A trade-weighted cost of capital is produced by weighting the cost of capital in 73 industries by their share of U.S. exports and imports.

Comparison between the United States and Its Trading Partners

The United States already has a tax system which adds more to the cost of capital than the tax system of its five major trading partners -- Canada, France, Germany, Japan, and the United Kingdom. H.R. 3838 would worsen the gap.

A standard assertion during the tax reform debate has been that the reduction in statutory corporate tax rates would improve the position of the United States vis-a-vis other countries. Rankings which incorporate various features of the corporate income tax, such as capital cost recovery systems, investment tax credits, statutory corporate tax rates, or corporate tax revenues as a percent of gross domestic product, show the United States with the lowest "corporate tax". This evidence is then used to make the case that the United States would have one of the most favorable corporate tax systems among its trading partners.

Such analyses are incomplete and can yield incorrect results because the taxation of capital income at the individual level is omitted. For example, each of the U.S.'s five major trading partners lessens the degree to which corporate capital income is taxed through relief given at the personal level while the United States does not. The impact of the total tax system on income from corporate nonresidential fixed investments must be taken into account.

When the interactions of corporate tax provisions with taxation at the individual level is taken into account, the United States under H.R. 3838 will be faced with a combined tax on corporate capital which is higher than any of the other countries considered. The results of this analysis underscore the importance of including all aspects of the tax system in evaluating the cost of capital. Looking at only one feature at a time obscures the true result.

Table V contains estimates of the combined effect of corporate and individual taxes on the cost of capital in the six countries based on one representative asset in the equipment and structure categories.[11] Other taxes, such as sales, value-added, and property taxes are treated as taxes on output and incorporated in the analysis. The "capital cost tax wedge" measures the percentage increase in the cost of capital due to taxes in each country. The "relative capital cost" columns measure the capital cost in each country as a percent of the U.S. cost for each type of asset.

When the appropriate taxes are taken into account, the U.S. tax system under current law, under the Administration proposal, and under H.R. 3838 rank last. (Under current law taxes in the United States raise the cost of equipment by 61.9

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[11] See The House Tax Bill: Would the U.S. Win or Lose? for method used.

percent and the cost of structures by 118.8 percent on a weighted average of all asset categories).[12] While the Administration's proposal would significantly lower the cost of structures relative to current law, it would only marginally impact on the cost of investing in equipment. H.R. 3838, however, would be devastating to trade, significantly raising the cost of equipment and lowering the cost of structures only slightly. Industries, such as light manufacturing equipment, would be particularly hard hit.

Conclusions

H.R. 3838 would alter the U.S. tax code in major ways. Yet, neither the Administration nor the Congress has studied the impact that these changes would have on the cost of labor and capital in the United States, on the competitive position of U.S. goods and services in markets at home and aborad, or on individual troubled sectors of the economy such as agriculture. The best that the White House could do at a critical juncture in the debate was to produce two administration economists who declared that the bill would not cause a recession in 1986--hardly an endorsement. Indeed, the bill was supported by the President and passed by the House with everyone completely in the dark as to the bill's overall and specific economic impact.

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[12] Brazell, David, Robbins, Aldona, Robbins, Gary, and Roberts, Paul Craig, The Cost of Corporate Capital in the United States and Japan, The Institute for Political Economy and The Krieble Foundation, 1985, Table 6, p. 29.

Considering the important role that taxation plays in the success of individuals, industries, and nations, it is irresponsible to alter the tax code without first conducting careful analysis of the economic impact. The analysis summarized in my testimony shows unambiguously that the combined effect of the individual and business provisions in H.R. 3838 would result in a higher cost of capital in the United States with adverse impacts on investment, productivity, income growth, and our competitive position in markets at home and abroad. Exports and noncorporate business would be most harmed by the bill.

In dynamic terms, H.R. 3838's adverse economic effects would produce a revenue loss. Moreover, in static terms it appears that the bill's drafters may have mis-estimated the revenue implications of major provisions of the bill. The revenue estimates prepared by the Joint Committee on Taxation are based on fiscal year receipts and on the 1981 distribution of tax returns filed in 1982. The 1981 sample misses the effects on taxpayer behavior of the 1981 tax rate reductions. The latest (1983) data reveal, for example, that upper income taxpayers are reporting a higher percentage of taxable investment income. Consequently, the reduction in the top personal income tax rate is likely to be a larger static revenue loser than the Joint Committee's analysis using the pre-tax cut sample indicates. It is unclear why 1981 data was used. The 1983 data has been available to the Treasury and the Joint Committee since early summer 1985.

The static estimates of the revenue to be gained from the expanded minimum tax are most likely overstated. Previous revenue estimates of similar changes have been several times more than final receipts. In 1969, when the first minimum tax was put in place, it raised a little over $100 million from individuals: the original estimate was $440 million. TEFRA raised only half the estimated $600 million minimum tax increase for individuals in 1983, and that ignores the loss of income and payroll taxes as a result of the sharp decline in the mining sector caused by the impact of TEFRA on profits. The minimum tax is not an income tax but a tax on the use of various provisions in the tax code. In the case of tax avoidance, shelters reorganize or cease, and no revenues are forthcoming. In other cases the tax could be triggered as a result of a firm experiencing an economic reverse. In this case the minimum tax would contribute to the economic hardship that the firm was experiencing.

The proposal to deny deductions for state and local taxes is not likely to raise the expected revenues either. State and local governments would be likely to experience pressure to rely more on business taxes, for example, a variation of Senator Roth's BTT, which would be deductible against business income. Instead of a revenue gain, there could be a revenue loss relative to current law because businesses would take the deductions at a higher average marginal tax rate than individuals. Marginal changes to the House bill financed by denying state and local tax deductions could end up adding to the deficit.

Table I-a

COST OF CORPORATE CAPITAL IN 1996 UNDER CURRENT LAW AND APPLICATION OF SUCCESSIVE PROVISIONS OF H.R. 3838

	Asset Aggregates		
Provisions of H.R. 3838	Equipment	Structures	Total Fixed
Current Law	26.8 %	13.0 %	18.7 %
Plus . . .			
Pension Limit Changes	26.9	13.1	18.8
Accounting Changes	26.9	13.4	19.0
Removal of ITC	31.2	14.1	21.4
Replacement of ACRS Depreciation	32.4	15.5	22.5
Corporate Rate Cut	30.9	14.2	21.1
Personal Rate Cut	28.7	13.2	19.6
Changes to Dividend Deductions	28.3	13.0	19.3

Table I-b

INCREMENTAL CHANGES IN THE COST OF CORPORATE CAPITAL DUE TO SELECTED PROVISIONS OF H.R. 3838

	Asset Aggregates		
Provisions of H.R. 3838	Equipment	Structures	Total Fixed
Pension Limit Changes	0.3 %	0.4 %	0.4 %
Accounting Changes	0.0	3.1	1.3
Removal of ITC	16.2	4.2	11.2
Replacement of ACRS Depreciation	3.7	10.4	6.3
Corporate Rate Cut	-4.8	-8.7	-6.4
Personal Rate Cut	-7.1	-6.9	-7.0
Changes to Dividend Deductions	-1.3	-1.3	-1.3

Table I-c

CUMULATIVE CHANGES IN THE COST OF CORPORATE CAPITAL DUE TO SELECTED PROVISIONS OF H.R. 3838 MEASURED RELATIVE TO CURRENT LAW

	Asset Aggregates		
Provisions of H.R. 3838	Equipment	Structures	Total Fixed
Pension Limit Changes	0.3 %	0.4 %	0.4 %
Accounting Changes	0.3	3.5	1.7
Removal of ITC	16.5	7.9	13.0
Replacement of ACRS Depreciation	20.9	19.1	20.2
Corporate Rate Cut	15.1	8.8	12.6
Personal Rate Cut	6.9	1.2	4.7
Changes to Dividend Deductions	5.5	-0.1	3.3

Table II-1a

CHANGES IN THE COST OF U.S. CORPORATE NONRESIDENTIAL FIXED CAPITAL BY ASSET IN MOVING FROM PRESENT LAW TO H.R. 3838 -- 1986

Aggregate Asset Classes	Percent Change in Cost of Capital
Equipment	8.4 %
Furniture and Fabricated Metal Products	10.6
Machinery and Equipment	8.6
Transportation Equipment	7.0
Other Equipment	9.1
Structures	2.6
Buildings	0.3
Other Structures	5.4
Nonresidential Fixed Investment	6.0 %

Table II-1b

CHANGES IN THE COST OF U.S. CORPORATE NONRESIDENTIAL FIXED CAPITAL BY ASSET IN MOVING FROM PRESENT LAW TO H.R. 3838 -- 1996

Aggregate Asset Classes	Percent Change in Cost of Capital
Equipment	5.5 %
Furniture and Fabricated Metal Products	7.7
Machinery and Equipment	5.7
Transportation Equipment	4.1
Other Equipment	6.2
Structures	-0.1
Buildings	-2.3
Other Structures	2.6
Nonresidential Fixed Investment	3.2 %

Table II-2a

CHANGE IN THE COST OF U.S. CORPORATE NONRESIDENTIAL FIXED CAPITAL BY INDUSTRY IN MOVING FROM PRESENT LAW TO H.R. 3838 -- 1986

Industry Group	Equipment	Structures	Total Fixed Investment
Agriculture	10.8 %	11.2 %	10.9 %
Mining	10.9	-3.2	1.2
Construction	4.5	0.4	3.3
Manufacturing	11.8	0.4	8.1
Nondurable Manufacturing	12.5	0.4	8.3
Durable Manufacturing	11.2	0.4	7.9
Transportation and Public Utilities	6.8	9.4	7.9
Wholesale and Retail Trade	6.5	0.4	4.0
Finance, Insurance, and Real Estate	5.8	0.7	4.1
Services	6.5	0.3	3.8
All Industries	8.4 %	2.6 %	6.0 %

Table II-2b

CHANGE IN THE COST OF U.S. CORPORATE NONRESIDENTIAL FIXED CAPITAL BY INDUSTRY IN MOVING FROM PRESENT LAW TO H.R. 3838 -- 1996

Industry Group	Equipment	Structures	Total Fixed Investment
Agriculture	7.8 %	8.3 %	8.0 %
Mining	7.9	-5.8	-1.5
Construction	1.7	-2.2	0.5
Manufacturing	8.8	-2.2	5.2
Nondurable Manufacturing	9.5	-2.2	5.4
Durable Manufacturing	8.2	-2.2	5.0
Transportation and Public Utilities	4.0	6.5	5.0
Wholesale and Retail Trade	3.6	-2.2	1.3
Finance, Insurance, and Real Estate	2.9	-1.9	1.3
Services	3.7	-2.3	1.0
All Industries	5.5 %	-0.1 %	3.2 %

Table II-3a

CHANGES IN THE COST OF U.S. NONCORPORATE NONRESIDENTIAL FIXED CAPITAL BY ASSET IN MOVING FROM PRESENT LAW TO H.R. 3838 -- 1986

Aggregate Asset Classes	Percent Change in Cost of Capital
Equipment	15.4 %
Furniture and Fabricated Metal Products	18.7
Machinery and Equipment	16.1
Transportation Equipment	12.9
Other Equipment	15.6
Structures	10.3
Buildings	10.3
Other Structures	10.2
Nonresidential Fixed Investment	13.1 %

Table II-3b

CHANGES IN THE COST OF U.S. NONCORPORATE NONRESIDENTIAL FIXED CAPITAL BY ASSET IN MOVING FROM PRESENT LAW TO H.R. 3838 -- 1996

Aggregate Asset Classes	Percent Change in Cost of Capital
Equipment	15.9 %
Furniture and Fabricated Metal Products	19.5
Machinery and Equipment	16.6
Transportation Equipment	13.2
Other Equipment	16.0
Structures	10.9
Buildings	11.0
Other Structures	10.9
Nonresidential Fixed Investment	13.6 %

Table II-4a

CHANGE IN THE COST OF U.S. NONCORPORATE NONRESIDENTIAL FIXED CAPITAL BY INDUSTRY IN MOVING FROM PRESENT LAW TO H.R. 3838 -- 1986

Industry Group	Equipment	Structures	Total Fixed Investment
Agriculture	17.8 %	17.9 %	17.8 %
Mining	17.7	2.5	6.3
Construction	11.8	10.4	11.4
Manufacturing	16.6	10.4	14.5
Nondurable Manufacturing	17.0	10.4	14.6
Durable Manufacturing	16.3	10.5	14.5
Transportation and Public Utilities	17.7	23.0	18.9
Wholesale and Retail Trade	13.5	10.4	12.3
Finance, Insurance, and Real Estate	12.9	11.3	12.1
Services	13.9	10.4	12.2
All Industries	15.4 %	10.3 %	13.1 %

Table II-4b

CHANGE IN THE COST OF U.S. NONCORPORATE NONRESIDENTIAL FIXED CAPITAL BY INDUSTRY IN MOVING FROM PRESENT LAW TO H.R. 3838 -- 1996

Industry Group	Equipment	Structures	Total Fixed Investment
Agriculture	18.6 %	18.9 %	18.7 %
Mining	18.4	2.7	6.7
Construction	11.8	11.1	11.6
Manufacturing	17.2	11.1	15.1
Nondurable Manufacturing	17.6	11.0	15.2
Durable Manufacturing	16.9	11.2	15.1
Transportation and Public Utilities	18.4	24.5	19.8
Wholesale and Retail Trade	13.8	11.0	12.7
Finance, Insurance, and Real Estate	13.2	12.0	12.6
Services	14.2	11.0	12.6
All Industries	15.9 %	10.9 %	13.6 %

Table III-1

AVERAGE MARGINAL TAX RATES ON INDIVIDUALS BY TYPE OF INCOME IN 1987

Current Law

	Wages & Salaries[1]			Interest		Nonfarm
	Average	Combined	Dividends	Rec'd	Paid	Business
All returns, total	33.1%	39.9%	35.9%	27.4%	-30.9%	39.3%
Lowest Quintile	15.1	24.8	4.8	5.7	-7.0	16.7
Second Quintile	23.1	31.9	16.1	16.0	-13.4	28.5
Middle Quintile	25.5	34.0	18.1	18.1	-18.0	30.2
Fourth Quintile	31.8	39.7	24.8	24.8	-25.1	36.8
Highest Quintile	38.5	43.8	42.4	37.7	-35.8	46.0

H.R. 3838

	Wages & Salaries[1]			Interest		Nonfarm
	Average	Combined	Dividends	Rec'd	Paid	Business
All returns, total	30.1%	37.2%	30.0%	24.1%	-26.7%	35.7%
Lowest Quintile	10.0	20.3	0.8	3.4	0.0	11.5
Second Quintile	24.3	33.0	17.1	17.0	-14.4	29.4
Middle Quintile	24.1	32.8	16.6	16.9	-16.0	29.0
Fourth Quintile	29.6	37.7	22.1	22.1	-22.6	34.5
Highest Quintile	34.3	39.9	34.8	32.0	-30.5	40.9 *

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[1] The average marginal tax rate on wages and salaries faced by the worker consists of federal income and employee social security tax rates. The combined rate includes both the employer and employee social security tax rates.

* This is higher than the statutory rate due to Self-Employment taxes.

Table III-2

AVERAGE MARGINAL TAX RATES ON INDIVIDUALS BY TYPE OF INCOME IN 1996

Current Law

	Wages & Salaries[1]			Interest		Nonfarm
	Average	Combined	Dividends	Rec'd	Paid	Business
All returns, total	36.6%	43.6%	38.1%	30.1%	-34.4%	42.7%
Lowest Quintile	19.2	29.2	8.2	9.1	-9.7	22.8
Second Quintile	23.0	32.6	15.2	15.2	-14.5	29.2
Middle Quintile	28.7	37.6	21.0	20.9	-21.0	34.5
Fourth Quintile	35.7	43.8	28.2	28.1	-28.6	41.0
Highest Quintile	42.5	47.8	44.5	41.0	-39.6	49.1

H.R. 3838

	Wages & Salaries[1]			Interest		Nonfarm
	Average	Combined	Dividends	Rec'd	Paid	Business
All returns, total	32.9%	40.2%	31.6%	26.3%	-29.2%	38.5%
Lowest Quintile	15.2	25.7	5.6	6.9	-8.6	19.6
Second Quintile	25.0	34.3	17.3	17.3	-14.4	31.3
Middle Quintile	26.2	35.4	18.1	18.3	-17.9	31.9
Fourth Quintile	33.5	41.8	25.5	25.6	-25.0	38.5
Highest Quintile	36.9	42.6	36.2	34.2	-33.1	42.8 *

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[1] The average marginal tax rate on wages and salaries faced by the worker consists of federal income and employee social security tax rates. The combined rate includes both the employer and employee social security tax rates.

* This is higher than the statutory rate due to Self-Employment taxes.

Table IV

THE EFFECT OF H.R. 3838 ON THE COST OF CAPITAL IN THE EXPORT AND IMPORT SECTORS

Change in Moving from Present Law to H.R. 3838 by		Trade-Weighted[1]	
Type of Capital	All Industries	Exports	Imports
Corporate in 1986			
Equipment	8.3 %	9.8 %	8.9 %
Structures	2.4	2.9	3.1
Nonresidential Fixed	5.9	7.6	6.5
Corporate in 1996			
Equipment	5.5 %	7.0 %	6.2 %
Structures	-0.1	0.3	0.6
Nonresidential Fixed	3.2	4.9	3.8
Noncorporate in 1986			
Equipment	15.4 %	16.6 %	15.2 %
Structures	10.3	12.6	10.3
Nonresidential Fixed	13.1	15.3	12.6
Noncorporate in 1996			
Equipment	15.9 %	17.2 %	15.7 %
Structures	10.9	13.4	11.0
Nonresidential Fixed	13.6	15.9	13.2

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[1] The cost of capital by industry is averaged using the share of total exports or imports attributed to that industry by the 1977 Input-Output Structure of the U.S. Economy as weights.

Table V

International Comparisons of the Cost of Capital

Country	Equipment Capital Cost Tax Wedge	Equipment Relative Capital Cost	Structures Capital Cost Tax Wedge	Structures Relative Capital Cost
Canada	26.0 %	71.2 %	84.9 %	75.8 %
France	10.6	62.5	43.3	56.8
Germany	18.3	66.8	76.5	72.4
Japan	43.4	81.0	87.9	77.0
United Kingdom	24.4	70.3	45.0	59.5
United States				
ACRS - Current	77.0	100.0	143.8	100.0
Administration	68.9	95.4	94.5	79.8
HR 3838	93.8	109.5	140.0	98.4

See *The House Tax Bill: Would the U.S. Win or Lose?* for the formulas used to prepare this table.

The **Chairman**. Let me ask each of you—and Dr. Weidenbaum's and Dr. Greenspan's statement have it, but I did not see it in yours, Dr. Roberts—that to the extent that we have any time to spend that we ought to be spending it on reducing the deficit rather than working on tax reform. Do I correctly paraphrase, Dr. Greenspan, Dr. Weidenbaum, what you said?

Dr. **Weidenbaum**. That is right.

The **Chairman**. And do you agree with that, Dr. Roberts?

Dr. **Roberts**. Well, if I thought that you were going to work on a real tax reform that would lower the cost of labor and capital, then I would recommend that as one of the keys to your deficit reduction program because I think that one of the best ways to help reduce the deficit is to help increase the performance of the economy. If you can get more output at every price by having a tax system that lowers the cost of labor and capital, you have helped the deficit reduction in a way that is relatively costless; certainly a lot less painful and bloody than what you have to do on the spending side.

The **Chairman**. I forgot to announce we go on a first-come, first-serve rule on questions. And the order I have today is Packwood, Moynihan, Bentsen, Grassley, Long, Roth, Mitchell, and Symms.

But the reason I asked that question, apart from what I expect will be some cuts requested by the President's budget, Medicaid, Medicare, most of the cuts that will be made under Gramm-Rudman, if we are going to get to $144 billion, most of them will not come in this committee's jurisdiction. We can work on tax reform and our portion of deficit reduction at the same time. I do not regard them as mutually exclusive.

On occasion I find people who say I wish you would not work on tax reform; work on deficit reduction who answer differently, Dr. Roberts, than you do. They just do not like the bill that we are on and prefer that we do nothing for fear it is going to be worse than the present law.

But the two are not mutually exclusive. And I assume that both Drs. Weidenbaum and Greenspan would not mind if we produced, in your judgment, a good tax reform bill.

Dr. **Greenspan**. Mr. Chairman, let me just say very specifically that that it is not an issue of time constraints. It is an issue of economic priorities. I just do not believe that the type of tax reform bill which is now before you is going to be significantly enough improved that it will have a beneficial effect unless and until the budget deficit is down and the cost of capital, which is inordinately high because of the deficit, is brought down.

The **Chairman**. You mentioned on page 3 of your statement, "only if the budget deficit can be brought down and long-term interest rates and capital costs fall as a consequence does elimination of the ITC and accelerated depreciation make economic sense."

A year ago, the first hearing we had in this committee when I became chairman was with a variety of economists of whom you were one. And we posed the question to you: What would you expect interest rates to do if we—this is 1 year ago—cut the budget deficit from the then projected $200 billion to $150 billion?

The normal response, if I were to pick an average, was 2 percent, I believe. And, Dr. Greenspan, you said 2 to 3 or maybe 1 to 2, but it was in that range.

If Gramm-Rudman is constitutional, if it works and if we get to a $144 billion deficit in fiscal year 1987, do you expect the interest rates to come down from where they are now?

Dr. **Greenspan**. Mr. Chairman, if you get to $144 billion in fiscal 1987, which I must say I perceive as rather remote, it also probably locks in the fiscal 1988 and 1989 track. I do not think you can get to balance by 1991. But if you get to a credible $144 billion or $150 billion in a way which is not just selling assets so it is a one-shot sort of thing, I think the financial community will assume that we have finally brought the deficit problem under control and that the inflation premiums in market interest rates would come down very substantially.

As best I can judge, there is 1 to 1½ percentage points decline already in long-term rates as a discount, hoping, I guess is the appropriate word, that something will happen.

The **Chairman**. That we might do something.

Dr. **Greenspan**. There is no question that the markets are now presuming that maybe something will happen. Previously, there was such a deep-seated cynicism that they believed nothing.

At the moment, having actually surveyed a few money managers who run very large portfolios, I have come to the conclusion that if the Gramm-Rudman procedure disintegrates and we go back to our old mechanism, we will retrace those improvements in long-term rates. Consequently, it is really urgent that this issue be pursued as bad as that bill is.

Dr. **Weidenbaum**. Mr. Chairman, could I offer an amendment to that analysis? I think expecting a 1- to 2-percent reduction in interest rates from what they otherwise would be is a reasonable expectation from achieving the Gramm-Rudman result. But I put in a hedge phrase—"from what they otherwise would be"—because I think, looking out to 1987, 1988, 1989, through 1991, I see a period of moderately rising inflation because of the rising money growth, money supply growth of recent months.

The **Chairman**. Regardless of whether we narrow the deficits down or not.

Dr. **Weidenbaum**. That is right.

The **Chairman**. If we do not, they may go up 4 percent. If we do, they may go 2 percent. That is what you are saying.

Dr. **Weidenbaum**. Or you may offset the rise. They may not rise at all.

The **Chairman**. Whereas they would otherwise rise 2 percent.

Dr. **Weidenbaum**. Yes. But I would be pleasantly surprised if interest rates would actually drop 2 percent between now—during the period between now and 1991 because I think the underlying trend is in the opposite direction. It is upward.

The **Chairman**. Dr. Roberts.

Dr. **Roberts**. Mr. Chairman, I do not believe that interest rates can fall enough to offset the loss of ITC and accelerated depreciation. The impact on the cost of capital of interest rates compared to taxation is small. And I think the change in the interest rate that it would require to offset the loss of those features is more extreme than is possible.

The **Chairman**. Let me proceed further. And do not forget to time me on the 5 minutes. I do not want to go over.

At the joint leadership meeting at the White House the other day, the administrator of OMB, Jim Miller, indicated—and apparently CBO is going to agree—that the budget deficit projection for 1987 will not be $220 or $210 billion, but about $182, $183 billion. And that CBO and OMB will not be far off of that.

Part of it, of course, is premised upon the 4-percent growth. Part of it, amazingly however, is premised on the assumption that the $11.7 billion in cuts that will go into effect now are outlays now with significantly larger budget authority coming forth in cuts in 1987. And the Director, Mr. Miller, indicated that if we adopt the cuts that they are talking about, in 1987, that the remaining budget totals, $108, $72, $36 billion, and so on over the 5 years, will almost be hit without further significant additional cuts just by virtue of the budget authority that we will cut in 1987. Now if that is all true, can we hope that the interest rates would then drop, if, indeed, people who loan money for 5 years or longer, believe that that is true?

Dr. Roberts.

Dr. **Roberts**. I think that you may have some impact on interest rates. I would not want to make the case for cutting the deficit rest entirely or even very strongly on an expected interest rate gain.

If you look over the last 5 years, we had extraordinary hysteria about the deficit and all the inflation it was supposed to cause and all the high interest rates it was supposed to cause. And over a period of time that the deficit increased in size by 400 percent, inflation collapsed and interest rates collapsed, including the real interest rate. Most of the inflation came out of the system between 1980 and 1982. And yet interest rates continue to fall significantly. We have just had another big rally in bond prices. We still seem to be in the middle of it.

And, therefore, the connections that have traditionally been assumed between deficits and interest rates do not really seem to be there. It does not mean that there would not be any affect on interest rates, and I would not want to say that there would not be. But I, myself, would not make my case for cutting the budget to rest entirely on the interest rate effects.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Mr. Chairman, first to welcome these remarkable Republican gentlemen, and, particularly, Dr. Weidenbaum who we do not see enough and to say what I think you may know. Yesterday, we heard from three econometricians who were uniformly bearish in their estimate of what would be the economic effect of the program, just as the three of you have been today. There was a uniform agreement that the tax bill we have would raise the cost of capital. I think the lower range was 12.5 percent proposed by Wharton.

There was an implied estimate that the bill could not be revenue neutral, much as Dr. Roberts said it. Even a static model is not neutral. A dynamic one on something like State and local taxes, which is the largest revenue raiser, there will be as I guess Martin

Feldstein proposed in the Wall Street Journal—the State and local governments will simply shift from individual taxes and property taxes to business taxes, and that is dynamic. Again, you get that revenue problem.

Could I put a question which we have never asked? And I ask it of all you three because you have had distinguished roles in this administration. You say it is going to be bad for business, bad for the economy, bad for the American people. Why did the administration propose it?

I will let you start where you will. I suppose in the order in which you testified. I mean you know there is a story here, but we have never gotten the story on it, have we?

Dr. **Greenspan**. I think it is important to distinguish various layers of priority. I being the member here who was not involved in that process can give my own guesses, and they can tell us what the facts are.

I have watched the whole issue of tax reform from the Republican side for a number of years. It started with an embracing of what essentially was a job creating capital investment process. It began in the 1960's and initiated the investment tax credit.

You remember the investment tax credit was largely sold at the time because it created jobs; not because it created improved investment or whatever.

Senator **Moynihan**. But, Alan, I guess I am only going back 2 years.

Dr. **Greenspan**. The reason I am trying to go back far enough is that I think there is a context here which is important.

It has always been a conservative, if not a surely Republican, point of view that there is something wrong with tax subsidies of any type. In fact, subsidies, per se, usually have a distorting impact.

There has always been the problem of how one looks at the investment tax credit either as a subsidy necessary to overcome something else or, as a way station to a lower corporate rate. A tax reform bill should endeavor to substitute lower tax rates for investment tax credits.

I think we are seeing in the administration's position an evolution, step by step, and not a reversal or an inconsistency.

Senator **Moynihan**. But you do think that they have gone to the point where whatever merit the case might have had it loses in the specifics—it loses it in the specifics of this proposal?

Dr. **Greenspan**. Yes; I say H.R. 3838 should not be supported by this administration.

Senator **Moynihan**. Should not be passed.

Treasury II was not that different?

Dr. **Greenspan**. Treasury II was on the margin in the other direction.

Senator **Moynihan**. It's marginally——

Dr. **Greenspan**. It is marginal.

Senator **Moynihan**. Less bad.

Dr. **Greenspan**. It is less onerous than this on——

Senator **Moynihan**. But not of a different order.

Dr. **Greenspan**. No; it is not.

Senator MOYNIHAN. Dr. Weidenbaum? We do not see enough of you.

Dr. WEIDENBAUM. I am in the happy position of reporting that I had left the administration before——

Senator MOYNIHAN. You will be surprised at the number of people who have had nothing to do with this tax bill. [Laughter.]

Dr. WEIDENBAUM. I was also a pre-Watergate member of the Nixon administration. [Laughter.]

Dr. WEIDENBAUM.I won't draw any further parallels. [Laughter.]

Senator MITCHELL. The next time you leave a job, we are going to look carefully at the place you just left. [Laughter.]

Dr. WEIDENBAUM. Now that is tenure.

But, seriously, I find the pressures of interest in tax reform has been bipartisan; it's nonpartisan in going back to many previous administrations, Republicans and Democrats.

And I do not want to dump on the general notion that we really need to improve the Internal Revenue Code. I think the administration's basic effort is commendable. The trouble is what they have come up with what started out, in my estimation, as a pristine scholar's effort to come up with a beautiful Tax Code for the long run, totally oblivious—and if you ask them, they admit it—totally ignoring such minor things as what is the impact on investment, economic growth, employment. Just minor matters like that.

But when they did have to crank in those minor matters in Treasury II and the House looked into it, that pristine tax bill became literally that hodgepodge that the House has sent over to the Senate.

And I think it is very hard to justify. And I have opposed, frankly, every one of those versions—Treasury I, Treasury II, the House bill. I think it is back to the showers.

I really do not see the need for haste in tax reform. To be candid, I have only heard two good reasons, and they are not economic. One, that tax reform will help bring the Democratic party back into the mainstream; and, two, which isn't any more glorious, tax reform will help solidify the blue-collar support of the Republican party.

These do not strike me as overriding reasons for the most fundamental revision of the Internal Revenue Code in a decade. And that is why in all seriousness in my opening statement I urged the committee to begin that truly comprehensive analysis, point by point, of the Internal Revenue Code, which can be the only basis for true tax reform.

Senator MOYNIHAN. Could I have Dr. Roberts speak, Mr. Chairman?

The CHAIRMAN. Your time isn't up yet, apparently.

Senator MOYNIHAN. Thank you.

Dr. ROBERTS. Pat, I have a good political answer to your question but instead I am going to tell you the truth.

This whole thing started because of the statement that David Stockman made to William Grider that was published in the Atlantic Monthly in November 1981. Mr. Stockman said that the 1981 tax cut was a trick, a Trojan horse, to lower taxes on the rich. And when he said that, everybody who had supported the 1981 bill began running for the woods. They were headed for cover.

And ever since, they all wanted to prove that they are fair. In the vernacular fairness means you tax business and you give it to individuals. It is sort of a crude, ignorant way of thinking about taxation.

Once Stockman made his allegation, and once the administration was headed for cover, the Treasury bureaucracy pulled off the shelf a bill that had been there 20 years. They try to hand it to everybody that comes along.

And they handed it to the administration which wanted to show it was in favor of fairness. It wanted to tax business and help individuals.

And that is the origin of Treasury I and from Treasury I to Treasury II, to H.R. 3838.

I was not in the administration at the time. Nevertheless, I warned them about the danger of tax reform when people were running for cover from the political fallout of Mr. Stockman's statement. And that is basically the origin of this bill.

Senator **Moynihan**. And Stanley Surrey's bill was there.

Dr. **Roberts**. Stanley Surrey's bill was sitting there waiting; been there for 20 years. And Stanley Surrey's people in the Treasury bureaucracy, a lot of them have been there. They were waiting too, and the thing came up. And that is the origin of the bill.

You see, the administration forgot all about what it's tax program was to be—to improve the economy by lowering the cost of labor and capital. And they forgot that it is possible to give somebody a tax cut in a way that throws them out of work. That is not fair. There is nothing fair about that. A tax reform that prices your products out of markets is not fair. None of this was considered when this bill came off the shelf.

Senator **Moynihan**. Since my time is up, sir, could I just ask once again: The panel does share the uniform judgment yesterday that this bill will raise the cost of capital?

Dr. **Roberts**. Yes.

Dr. **Weidenbaum**. That is right.

Senator **Moynihan**. Mr. Chairman, I think we——

Dr. **Roberts**. There is no doubt about it whatsoever.

Senator **Moynihan**. Thank you very much, Mr. Chairman.

Thank you, gentlemen.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. As my friend from New York has stated, yesterday we had the unanimous opinion on the part of representatives of DRI, Wharton, Chase Econometrics saying the tax bill would slow capital formation, reduce productivity growth rate and erode international competitiveness.

And then this morning the Commerce Department released the figures on trade. And they show that our deficit has gone to $148.5 billion up from $123 billion last year. Deterioration of the bilateral trade deficit with Japan was a major cause of it. We have seen a trade deficit that has cost us hundreds of thousands of jobs, pushing us deeper into debt with the rest of the world.

And then I looked at the numbers on productivity, again, released this morning. And those show that productivity in the nonfarm business sector has dropped; it fell 1.8 percent. And I know that the administration is counting on the 2-percent productivity growth to reach their 4-percent long-term economic growth.

Then I listen to my friend Alan Greenspan talking about the tax bill being a risk that is a larger risk than we should take.

It seems to me that we get back to—I remember the quote of one economist who said what this is is really a riverboat gamble. And we are doing it with the only economy we have.

Do you think that Treasury II or Treasury I or the House bill are consistent with this attempt to increase productivity on the part of the administration? Can anyone justify that or give me a reason for it?

Dr. **Weidenbaum.** I sure cannot. I think all three versions of tax reform go the other way. By dampening down saving and investment incentives, they reduce investment, reduce productivity increase and reduce the competitiveness of American industry. Also by reducing the incentives to research and development, they weaken the competitiveness of the American economy.

It is the wrong bill at the wrong time.

Senator **Bentsen.** Dr. Roberts, there has been a lot of controversy about whether or not—and you touched on it—the investment incentives added in 1981 had a significant impact on investment. A lot of conflicting factors are involved—interest rates skyrocketed and that kind of thing, and we had a recession. But I was looking at the report of Michael Boskin from Stanford saying that we have had a 20-percent rise in net investments since 1981 that could be directly attributed to incentives. Moreover, the Center for International Business Cycle Research, Columbia, concluded there had been a 35-percent rise during the recovery, as compared to a 21-percent rise in 1975 during that recovery, and the 20-percent rise in the comparable 1961 recovery.

What is your impression as to whether or not those incentives have encouraged investment?

Dr. **Roberts.** Well, Senator, I think the record is very clear they have. Not just from that research, but from the economic reports of the President, which have shown that investment's share of the increase in GNP growth in 1983 and 1984 was much larger than in previous recoveries. There is a good deal of evidence which has been amassed to show that the incentives were effective.

I think you have to keep in mind also that you took back most of the incentives in 1982 when you passed TEFRA. You took back—except for structures—you took back almost all of the investment incentives. Certainly, the incentives put in for equipment were just taken back before they ever went into effect.

And so the net effect after TEFRA of the 1981 bill was very light. And to have the type of result that Mr. Boskin reports and that you can also find in the economic reports of the President and in other places is quite significant.

Senator **Bentsen.** Dr. Greenspan, we have talked about tax subsidies and how if we could wait long enough and avoid the transitional costs that ultimately this tax bill might be where we would want to be. But I listened to the economists yesterday talking about the bill. One of them said in 5 or 6 years we would get back to even, get back to where we are. And another one talked about, well, maybe in 15 or 16 years it would all work out.

I am terribly concerned about that next 5 or 6 years, and even more, I guess about the next 15 years. But cannot we say in some instances certainly, even in the long run, that we might want some incentives—certainly from the standpoint of the national defense when we are talking about maintaining in a diversified manufacturing base for our country—cannot you justify the incentives under those circumstances?

Dr. **GREENSPAN**. Well, Senator, I think we have to distinguish between incentives and subsidies. In many respects, they are quite different. I mean I would consider, for example, lowering the corporate tax rate, creating incentives. And, obviously, that is not a subsidy.

If we have particular areas of the economy which are required for national defense, I have always believed that should be part of the defense budget and appropriated in the usual manner rather than in an indirect manner. I would not like to use the Tax Code for endeavoring to put in place various different forms of industrial structure which we designate as required for the national defense. We should fund that directly.

Senator **BENTSEN**. Dr. Greenspan, I might differ a little with you in that. After looking at some of the things my friend Chuck Grassley has discovered in the defense appropriations, I think the Tax Code might work more effectively than some of the appropriations as a way of subsidizing the Defense Department.

Thank you very much .

The **CHAIRMAN**. Senator Long.

Senator **LONG**. Mr. Weidenbaum, I heard Mr. Roberts say at the conclusion of his statement that if you want tax reform, you should start from scratch. Do you agree with that?

Dr. **WEIDENBAUM**. Yes; I do. That was the thrust of my recommendation to the committee.

Senator **LONG**. What is your thought about that, Dr. Greenspan? Do you think we ought to just try to improve the bill or do you think we ought to start from scratch if we want tax reform?

Dr. **GREENSPAN**. Senator, if you start from scratch, you might as well just stop. There is not enough time before the next Congress convenes.

Senator **LONG**. You would propose trying to improve this bill?

Dr. **GREENSPAN**. I would say if it is feasible. I must say that I suspect that there may not be enough time to do what is required to make this into an acceptable bill.

Senator **LONG**. Now, Dr. Roberts, I want to ask you a question. I might want to ask the other two the same question.

Would you please give me your thoughts as to why the 1981 tax cut did not work out the way we had in mind, at least in the short run. When it went into effect, we had a recession rather than a pickup in the economy. Do you mind explaining to us briefly why you think that did not work out the way you would have liked?

Dr. **ROBERTS**. Certainly, Senator Long. I think that is a very good question. I would like to answer that. What happened, Senator, the 1981 tax cut, when it was proposed, was widely misinterpreted as a big stimulus to consumer spending.

It was not seen in the supply side terms that it had as its purpose. It was seen as a big effort to pump up the economy with increased consumer spending. And the people who were misinterpreting it that way created an inflation hysteria. If you go back to 1981, you look at the predictions, all the massive inflation we are going to have, this affected the Federal Reserve Board. Mr. Volcker and the Board were convinced that this tax cut was going to cause a terrible inflation. You have to remember that inflation was already about 13½ percent. And they thought they were going to be blamed.

And they reasoned that since the administration had some monetarists in office—you know, monetarists account for inflation in terms of money growth—they reasoned that if the Federal Reserve did not provide any money growth, they could not be blamed for this inflation.

So they went home and turned off the money. There was not any money growth in 1981. That is just the clear record.

The Federal Reserve acted in a self-protective way against what they thought was an irresponsible, inflationary fiscal policy so that they would not bear the consequences. Now, obviously, everyone greatly overestimated the power of a change in fiscal policy compared to the power of monetary policy. When you turn off the money, it does not matter what the Government is doing on the fiscal side. That is why we had this terrible recession.

Let me just add one last thing. What also happened, and this is the main source of the deficits, is the inflation rates completely collapsed as opposed to everybody's projections. No one foresaw that collapse in inflation.

If you look at the budget of the United States, up front it always tells you that if inflation falls, you lose revenues faster than you curtail spending.

Senator **LONG**. I would like to hear what the other two think about that.

Dr. **WEIDENBAUM**. I would have a somewhat different explanation of the phenomenon. And I don't go for the conspiracy theories particularly.

Dr. **ROBERTS**. This is not a conspiracy theory. This is people acting in keeping with the conventional wisdom of the time.

Dr. **WEIDENBAUM**. The fact remains that the tax cuts enacted in 1981 were substantially larger than the proposal in the original economic recovery program, and the spending cuts that were to accompany the program were substantially lower. This produced the specter of large, continuing budget deficits.

And, yes, that did frighten the Federal Reserve sufficiently to slow down the growth of the money supply. And that worsened the recession and increased the budget deficits.

But I think there is enough blame to go around both ends of Pennsylvania Avenue as well as Constitution Avenue. That is, those tax cuts were more generous than in the original package, and the spending cuts really were not delivered.

Senator **LONG**. Dr. Greenspan.

Dr. **GREENSPAN**. Three economists usually have five explanations. You will only have three this time.

I disagree with both of my colleagues. You have to remember at that time that the Federal Reserve was confronted with the tail end of what in historical terms was an extraordinary acceleration in inflation. It had been getting actually quite disstabilizing. The policies which were originated with the monetary growth targets of 1979 and carried through that period were essentially a long-term change in posture of the Federal Reserve.

I certainly do not deny that the constraint in money supply did contribute to the decline in 1981, but I suspect that had that not been done it would have merely allowed the economy to continue unstable for a year or so more and then the decline would have been far more severe than that which we ran into.

So I think that the Federal Reserve was caught in a very difficult potentially accelerating inflationary environment which it chose to contain with admitted cost to the economy. In retrospect, I think that was the right policy, and I think that rather than pillar the Federal Reserve, I think they deserve our thanks for reversing a very fundamental and dangerous trend that had begun subsequent to the debt now and was carrying through into the early 1980's.

Senator LONG. Thank you.

The CHAIRMAN. Senator Roth.

Senator MOYNIHAN. Mr. Chairman, could I just interject to say that I did not find those three statements incompatible.

The CHAIRMAN. I agree.

Senator MOYNIHAN. I have recognized the same events from what each of those gentlemen said.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

Let me start out by saying that it seems to me the most important problem that we face as a nation and as a Congress is how to set the tax policy that will help this country become competitive in world markets. And it seems to me, further, that we are in a period of great change. We are at the beginning of a technological revolution of which none of us are certain as to where it will lead.

And the problem I see with the tax package handed over to us from the House of Representatives as well as Treasury II does not really deal with the kind of long-term tax policies we have.

Now my first question: Am I right as to that being the key question? And isn't that why the House bill is an invitation to disaster? Dr. Weidenbaum.

Dr. WEIDENBAUM. I think the House bill is a bad bill. And I share the second part of your sentiment. But, very frankly, I think that spending control is a more urgent national priority in 1986 than tax reform.

Senator ROTH. I am not asking for priorities because I agree with you on the importance of deficit reduction. on the spending side. But it seems to me to set the kind of policies for long-term growth requires many things. But right now I want to just concentrate on the kind of tax policy we need; not the priorities as to how you place it.

Dr. WEIDENBAUM. I share your view, then, as you stated, that a revised tax system could and should contribute to enhancing America's competitiveness in the world economy.

Senator ROTH. Dr. Roberts.

Dr. ROBERTS. I agree with your statements, Senator Roth. And I might add that the dynamic revemue losses of H.R. 3838 would offset a very large amount of any gains you are going to get under this Gramm-Rudman process. If you get a tax bill that is going to lose revenues in a dynamic way while you bloody your heads trying to cut the budget, you won't see it translating into any effect on the size of the deficit, and will have struck out on both issues.

So I would, again, emphasize that the tax system is going to have a lot to do with your success in reducing the deficit. Or else it is going to have a lot to do in preventing your ability to reduce the deficit.

Dr. **Greenspan**. Senator, I think we ought to just take a moment and explain why I think most economists would say that H.R. 3838 is a revenue loser.

If you go through the calculations, assuming that you come out static revenue neutral, which you will always find that the revenue estimaters have an incentive to come out that way, and they will change the structure ever so slightly to make it happen that way, if you enact a law, you can be certain that those on whom you impose the tax will endeavor to find a way to change their behavior to avoid the tax. And as Dr. Roberts pointed out, when we hit the minimum tax increases of recent years, we invariably did not get what we wanted, and the reasons are very clearcut. It was not an accident that they were always run in one direction. It is that you cannot assume that persons on whom you are going to impose the tax will not try to find a legal way of avoidance and will almost certainly succeed in part.

Therefore, any revenue-neutral bill calculated in the conventional way has got to be a revenue loser of an indeterminant amount.

Back to your original question: I don't quite go along fully for the reason that this economy is changing probably irreversibly more toward less physical volume type of activities, which are representative in manufacturing, and more conceptual. And when we begin to look at the way we impose our tax system, if we can define a capitalized asset, we require that it be depreciated and handled in a way in which the tax effects spread over the presumed life of the asset, very similar types of activity which we have for generations accomplished in the manufacturing area by producing capital goods. We are going to start to create in a lot of computer-based, high technology software dominated types of industries by R&D or other forms of directly expensed items which are identical to the investment process.

So in the sense that we continue with this distinction between requiring capitalization of certain physical assets written off according to a certain schedule but maintain the historic accounting procedures with a number of things like institutional advertising, research and development, training costs, software production, all of which are immediately expensed, those types of issues, I think are not addressed appropriately in this bill.

And if you are trying to focus on where the economy is going longer term and how one should draft tax legislation to address that issue, then I have to think—I think we ought to go back and rethink how not the tax law reads, but how we automatically accept historic accounting provisions which really are obsolete.

Senator **Roth**. Could I ask one followup question?

The **Chairman**. Let's go around because we have six people that haven't been able to ask at all, and we are taking a little longer than normal on our questions.

Senator Mitchell.

Senator **Mitchell**. Thank you, Mr. Chairman.

Gentlemen, I was interested in your response to Senator Moynihan's question regarding the origins of this tax bill, and I was struck by the fact that not one of the three of you, in relating the origin of how this tax bill got here ever mentioned President Reagan. I kind of felt like someone who had just read the history of the Civil War that didn't mention Abraham Lincoln.

I have a different recollection or perhaps one that supplements yours. Almost exactly 2 years ago tonight, I sat in the well of the House with the other Members of the Congress to hear a State of the Union Address in which the President spoke at length and affirmatively about the subject; told us and the American people how he was going to appoint a sector of Treasury to conduct a study; how all through 1984, which not coincidentally was a campaign year, the President talked of the need for tax reform and referred to this upcoming report. After the report was issued in September 1984, all through 1985, the President campaigned around the country talking about the need for tax reform.

And, Dr. Weidenbaum, if you read those speeches, you will see that they were essentially arguments for tax cuts or telling the people I want to cut your taxes as opposed to what we call tax reform.

Now you have testified here today in very strong terms in opposition of the House bill. You have also acknowledged under questioning that there is not much difference between the House bill and the President's bill. Therefore, I would like to ask you two questions: Would you care to supplement your responses to Senator Moynihan's questions and agree that President Reagan has had some role in the tax reform matter in bringing this bill to us? And on this issue are you telling us, gentlemen, you, Dr. Weidenbaum, former Chairman of President Reagan's Council of Economic Advisers; Dr. Roberts, you, former Assistant Secretary to Treasury in the Reagan administration; and, Dr. Greenspan, you, former Chairman of President Ford's Council of Economic Advisers—are you, the three of you, telling us that on this issue President Reagan is wrong?

Dr. **Weidenbaum**. Senator Mitchell, first of all, your factual recollection, to the best of my knowledge, is impeccable.

One of the joys of being a private citizen, I no longer have to defend every action, every statement of the administration of which I am a part. I have opposed Treasury I in public as well as in private. I have opposed Treasury II. And I have opposed the House bill.

I think this is a misguided effort.

Senator **Mitchell**. Your answer to my question is yes and yes?

Dr. **Weidenbaum**. Yes; yes.

[Laughter.]

Dr. **Roberts**. Let me answer your question this way, Senator. I think——

Senator **Mitchell**. No; no, Dr. Roberts, we ask the questions. [Laughter.]

Dr. **Roberts**. All right. I will answer your question as you asked it, which is what I meant to say. I think that the content of the tax reform as opposed to the principle of having a tax reform are two different things in the political process.

I think the President had in his head the concept of having a tax reform, and I do not think he exercised very detailed or good control over the content of this concept, which was put together by a permanent staff at the Treasury.

And so I think, then, there came a divergence between the notion we are going to have a tax reform as a concept and the detailed content that emerged. And I think that, in my view, it was a management——

Senator **Mitchell**. But, Dr. Roberts, President Reagan sent a bill to Congress. Surely you are not suggesting that the President did not know what was in that bill.

Dr. **Roberts**. I doubt that he knows—given the amount of work I had to spend to get just some idea of what is in this bill, I doubt he knows what the content of this bill is, much less in terms of its aggregate impact on the economy. I doubt your staff knows that. Joint committee doesn't know it.

Senator **Mitchell**. Oh, my staff knows it.

We might not, but our staff knows it. [Laughter.]

Dr. **Roberts**. I spent many weeks with some very good human resources trying to prepare the report on which my testimony is based today, and I can guarantee you the administration has no such document, or the Congress. Therefore, it is very possible for a political process to produce a bill without being well acquainted with its impact.

Senator **Mitchell**. May I take your answer to be yes and yes, too, except that the President does not know the details, but the details are wrong?

Dr. **Roberts**. I think the President was very effective in moving the notion of tax reform forward. I think that is different from how this particular bill moved forward. That is my answer.

Senator **Mitchell**. Could Dr. Greenspan answer briefly, Mr. Chairman?

The **Chairman**. Can you say yes and yes in 5 seconds?

Dr. **Greenspan**. I doubt it, but I will try to get close. I happen to be the only one of the three here who apparently thinks that there is some very important favorable things in the tax bill approach. I do think that the ultimate removal of tax subsidies and substituting lower rates both on individuals and corporations is desirable.

I marginally supported Treasury II hoping that it could be improved upon. Even though I grant you that the broad principles of this bill are not significantly different from Treasury II, I think it does go sufficiently far in the wrong direction to tilt it beyond the point where it is safe to try to implement all of its provisions.

So I do not think the President is wrong-headed in his particular approach. I do think, however, that he should not be supporting even implicitly H.R. 3838.

The **Chairman**. Senator Symms.

Senator **Symms**. Thank you, Mr. Chairman.

Dr. Weidenbaum, you said that tax reform has proceeded in the wrong way. You said they determined the rates, then eliminated the preferences to come up with those rates in a static environment. Are you saying, then, we should proceed by setting the basic principles of what we want to achieve and then go back and see where the rates would come out?

Dr. **Weidenbaum**. Precisely, yes, sir.

Senator **Symms**. Are you familiar with the plan that has been developed by Drs. Hall and Rabushka?

Dr. **Weidenbaum**. Modestly; yes.

Senator **Symms**. Does that start on the right track by removing double taxation of equity capital and single taxation of savings and start on a progrowth basis? Is that where we should be starting?

Dr. **Weidenbaum**. I hesitate to come down for or against it at this point, but that would be true tax reform.

Senator **Symms**. That would be tax reform in your definition?

Dr. **Weidenbaum**. Yes, sir.

Senator **Symms**. Dr. Roberts, I read an article here one day in this committee sometime along in December that you had written in the Wall Street Journal. I read it aloud and it brought a great roar of approval in the committee room and some laughter. You made reference to the fact that it appeared to you that the people at the Treasury and the White House and the Congress had given up on supply-side economics and given up on demand-side economics and now they had a new course of action and that was blind-side economics with this tax bill.

Would you want to quantify that for me slightly?

Dr. **Roberts**. Well, I quantified it a good deal in a bunch of tables at the end of my testimony.

Senator **Symms**. Let me ask you this: If we started with the tax reform proposal that was true tax reform on a basic principle—not the specifics of Hall-Rabushka, but the general principle—would you call that blind-side economics?

Dr. **Roberts**. No; not if you start with true principles. And I think that you have to know what the true principles are. They are not, I think, what Dr. Greenspan has suggested. He thinks it is to remove subsidies to investment.

I think that it is very easy if you look at the Tax Code piecemeal to find subsidies; for example, if you look just at the taxation of capital source income at the corporate level. I think to have true tax reform, you have got to address the fact that the U.S. Tax Code has a very terrible tax bias against saving. That is income from saving and investment is subject to multiple taxation, and that is the main source of nonneutrality in the Tax Code.

Now given that structure of the code, many of the things that Mr. Greenspan thinks are subsidies are not subsidies at all. They merely alleviate in part this multiple taxation of capital source income because capital income is taxed at the corporate level and taxed again at the individual level. Companies pay dividends out of taxable income and it is taxed again.

So I think that to——

Dr. **Greenspan**. Can I just raise one question? You are mischaracterizing what it is that I am saying. I mean I do not disagree

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with what you are saying. I was merely referring to certain aspects of the Tax Code, so don't mischaracterize what I have said.

Senator **Symms**. Just to interject here, in other words, what you are saving is that, for example, we have developed a system in hard rock mines called percentage depletion. And some people call that a preference; a subsidy, so forth. What you are saying, Dr. Roberts, and, Dr. Greespan, check me if I am incorrect on this, is that all that is is a method of mitigating the anticapital bias in the tax law.

Dr. **Roberts**. In the Tax Code. That is right.

Senator **Symms**. So there isn't anything evil about it. It was put in there for a good reason by a Congress procedure.

Dr. **Roberts**. That's right. As long as you have a Tax Code that subjects income from savings and investment to multiple taxation, there are no subsidies in the code.

If you stop the—if you eliminate the tax bias against saving in the code, then many of these factors that are called, in my view, erroneously, subsidies or preferences, the need for them would drop out, and they would drop out. And that would be a true reform. But you have to start by eliminating the bias in the code against saving. That is where you start. If you do not start there, you do not have true reform.

Senator **Symms**. I want to get one last question. I would like to ask each of—I will have to wait until my next round.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman.

I was very interested in all three of your testimonies. I was actually pleased to hear Mr. Greenspan say that he was marginally supportive of the President's proposal. And I think that your testimony raises a basic issue about how you view our tax system in terms of economic growth and investment and so forth.

And I was just curious that if you were going to devise the tax system that you would like to see, would you tax any income from capital?

Dr. **Greenspan**. Is that directed to me?

Senator **Bradley**. Well, I would like each of you just to respond.

Dr. **Greenspan**. No; I would eliminate the capital gains tax.

Senator **Bradley**. Dr. Roberts, would you tax any income from capital? I take it from your previous comment you would not.

Dr. **Roberts**. I think if I could really just design it the way I wanted it, I would not tax income at all, any income.

Senator **Bradley**. All right. You would not tax any income.

All right, Dr. Weidenbaum?

Dr. **Weidenbaum**. I would eliminate the double taxation of dividends and suggest that would be a constructive way of slowing down the wave of takeovers.

Senator **Bradley**. What about the corporate income tax? I mean should we think about eliminating the corporate income tax since the argument has been made that it is just passed on in higher prices, et cetera? Dr. Greenspan.

Dr. **Greenspan**. Yes; I would say if you had an ideal tax system, I would eliminate the corporate.

Senator **Bradley**. All right. Dr. Roberts.

Dr. **Roberts**. If you are going to tax income, you ought to tax it at one level or the other and not on both.

Senator **Bradley**. You do not want to tax income though. You just said that.

Dr. **Roberts**. I would prefer to dispense with income tax altogether.

Senator **Bradley**. That includes corporate income tax?

Dr. **Roberts**. Yes.

Senator **Bradley**. All right. Dr. Weidenbaum.

Dr. **Weidenbaum**. I would like to see the corporate income tax phased out.

Senator **Bradley**. The reason I ask these questions is that I just wanted to make as clear as possible your point of view, which is that there should be no tax on income from capital—no corporate tax, no capital gains tax, and a variety of other suggestions.

Now that is the point of view each of you have for your own assessment of its effect on the economy. Now this committee has to grapple with other issues. And one of those issues that we have to grapple with is a question of simple fairness.

I think if you took a vote on this committee right now, who on this committee would like to abolish the corporate income tax, you would not have five votes. Or how many on this committee would like to eliminate the capital gains, you would not have five votes.

And so we have to kind of bring it back to the realistic place where we are. And you have to address a question of if you do not tax capital, neither a corporate income tax nor any individual tax on income from capital, then you are left with, I think, a tax that is paid by individuals in a way not based on ability to pay.

Dr. **Greenspan**. May I respond to that?

Dr. **Weidenbaum**. I have to say yes, but, in other words, in my view, eliminating, say, the double taxation of dividends would still mean full reporting and payment by the individual of the fruits of capital.

Senator **Bradley**. I did not mention that. I mentioned the corporate and the capital gains.

Dr. **Greenspan**. Senator, can I respond to that?

Senator **Bradley**. Yes.

Dr. **Greenspan**. Capital does not pay taxes, individuals pay taxes.

Senator **Bradley**. On the basis of ability to pay.

Dr. **Greenspan**. Let me address a very technical question.

We have a very complex tax structure. Ultimately, all taxes are paid by individuals. Institutions which have capital are merely a mechanism by which we readjust how that happens.

One can do whatever one wants with respect to the issue of fairness or equity or distribution of taxation wholly from the ultimate place where taxation resides, which has got to be on people. You cannot tax a railroad car or an airplane or a corporation. It is people. And, therefore, when we talk about eliminating these various different issues, what we are saying is that they are technically inappropriate economic mechanisms to transfer taxes from one individual to another. If you are going to tax, do it directly.

Senator **Bradley**. So that would argue for an integration of the corporate and individual income tax system.

Dr. **Greenspan**. Yes, sir.

Senator **Bradley**. And a payment of tax on undistributed earnings.

Dr. **Greenspan**. Yes, sir.

Dr. **Roberts**. Mr. Chairman, on my own time could I briefly answer this question?

The **Chairman**. No; not until we go around again.

Senator Chafee.

Senator **Chafee**. I thank you, Mr. Chairman.

Dr. Greenspan, you just said that you favored Treasury II, but that when it got to the House, the tilt was such the changes that were made just made it unpalatable to you.

My question is—and, in a way, you have touched on these in your testimony, which, regretfully, I wasn't here for. We had another meeting. But could you tell me what you would do if you were us, without being bogged down with political problems and otherwise, what would you do to fix up the Treasury II or the House bill?

Dr. **Greenspan**. I would focus on one area only. And that is the transference of tax incidence from the individual code to the corporate code. I think the extraordinarily——

The **Chairman**. That is the whole bill.

Dr. **Greenspan**. I am sorry.

The **Chairman**. That is the whole bill basically.

Dr. **Greenspan**. Well, no; it is not. I think the whole bill from Treasury II to H.R. 3838—I'm sorry, is that what you mean, Mr. Chairman?

The **Chairman**. No.

Senator **Chafee**. I do not want to get mixed up on whose time we are on.

The **Chairman**. Go ahead.

Dr. **Greenspan**. What I am saying, basically, is this: The cutting of the individual tax rates down into the thirties is very desirable at the margin. What H.R. 3838 does is to move much too much in the way of tax burden from individuals to corporations. If that could be very sharply curtailed or even eliminated—because I thought even in Treasury II it was excessive—then I think the bill would be very substantially improved and the dangers that it now holds to the economy and to investment would be very dramatically reduced.

Senator **Chafee**. I am going to ask you two questions. First of all, the President's bill, Treasury II, shifted $100 billion. We can argue whether it is 110 or 120, but let us say $100 billion from individuals to corporations. And the House bill shifted 140. What would you say would be accepted?

Dr. **Greenspan**. I think less than 100. I did think that Treasury II was excessive as well, but capable of being——

Senator **Chafee**. All right; 50 to 70?

Dr. **Greenspan**. I would prefer zero, but if it were 50, it would probably be, depending on how that was structured, a quite superior bill to what we are now looking at.

Senator **Chafee**. Now you say in your final paragraph of your statement: "The major adverse impact of the tax bill is likely to be on manufacturing industries, which have already been depressed significantly."

I think all of us on this committee feel the way you do. That this has gone too far, and that we should do something about it.

How? Is it through the ITC? Yesterday we had suggestions: All right, keep the ITC at 5 percent and perhaps the depreciation schedules are not that important. Others say pull back the depreciation schedules as far as manufacturing equipment goes. What is your tilt?

Dr. **GREENSPAN**. Well, Senator, my testimony focused upon need to bring down the cost of capital by reducing the budget deficit appreciably. That would then make the whole capital investment problem far more easily handleable.

I would at this stage feel far more comfortable that instead of rushing ahead with this just to get a bill passed basically to do what is far more important to reduce the cost of capital, then take a look at the structure of how we deal with what probably in my judgment at least should be altered; namely, a transfer of some of the tax subsidies of which I include the investment tax credit, certain accelerated depreciation and substitute for that cuts in the marginal corporate tax rate.

Senator **CHAFEE**. Dr. Weidenbaum, is this bill beyond redemption?

Dr. **WEIDENBAUM**. Yes; yes.

Senator **CHAFEE**. That is concise. [Laughter.]

Senator **CHAFEE**. And one final question, Dr. Greenspan. You have also touched on the capital gains. Frankly, I personally do not see an awful lot of difference between 20 and 22 percent or 18. And we have had the venture capitalists in here, and they all seem quite satisfied with 20 percent.

I was cut in on my time a brief bit so I am allowed 30 more—I will allow myself 30 more seconds. [Laughter.]

Senator **CHAFEE**. How important is the change in the capital gains?

Dr. **GREENSPAN**. I think that very important changes were made in earlier legislation in 1981. My view is the lower the better, but clearly we are far better off now than we were 10 years ago.

Senator **CHAFEE**. Well, I guess my real question was is the 2 percent a——

Dr. **GREENSPAN**. No; I would not consider that a major issue.

Senator **CHAFEE**. Thank you.

Thank you, Mr. Chairman.

The **CHAIRMAN**. Senator Heinz.

Senator **HEINZ**. Mr. Chairman, let us just double check one critical issue. Alan Greenspan just said that we really need to act on the deficits, do what we can do, therefore, to lower the cost of capital, and then and only then will we be in a position to make intelligent choices about tax reform because within making those choices we are going to have to make decisions about depreciation, investment tax credit, R&D tax credits and the like. And I see that Dr. Greenspan generally agrees with my rephrasing of what he has said.

Do the other two of you agree that we should under no circumstances move ahead with tax reform, either this approach or a new chairman's approach, until we have addressed the budget deficit?

Dr. **WEIDENBAUM**. Let me put it this way: I think the committee should set aside the tax reform bill for 1986 because we will have a stronger, more competitive economy without it.

However, because of the fundamental needs to reform the Internal Revenue Code, you should set in motion a detailed staff review of every section of the code to do literally a benefit-cost analysis as to whether each one of those special provisions of the code is worth it. And that will be the basis for a true, comprehensive tax reform.

Senator **HEINZ**. Dr. Roberts, do you agree?

Dr. **ROBERTS**. I am certainly in favor of reducing the deficit, Senator. I think that a real tax reform would certainly do more to reduce the cost of capital than you can achieve by reducing the deficit.

Senator **HEINZ**. Now there undoubtedly are some economists—we have not met them yet—who might say that either the administration bill or the House bill are going to be economic boons or at least no worse than neutral to this country. Maybe I am wrong in that assumption, but there are some down at the Council of Economic Advisers—and at least two of you have some familiarity with that group.

What will those proponents of either H.R. 3838 or Treasury II—why will they be able to argue that one or both of those bills is good for the country, and where, in your analysis, is their analysis wrong?

Dr. Greenspan.

Dr. **GREENSPAN**. Well, actually as I stipulate in part of my testimony, there are certain positive aspects to the direction of altering the way the Tax Code reads with respect to capital investment. In other words, I am in favor, as, in fact, is implicit in the tax reform thrust, of substituting a lower corporate tax rate for the investment tax credit and for accelerated depreciation.

Senator **HEINZ**. I am well aware of what you are in favor of. My question is: Those people who are looking at what has been delivered to us, where are they wrong?

Dr. **GREENSPAN**. No; no, I am saying that that is where they would come out on the favorable side. Where I think they are mistaken is, one, that the transition aspects of this bill, as well as the short-term impacts on the economy, are probably more significant than they are willing to acknowledge. And I also suspect that they look at it in noneconomic sense that there is something desirable from a social or political sense to engender a bill of this nature.

There is no question that there are positives involved in the bill. I also suspect that where most of them would go off is, I think, that they fail to take into consideration that we are in a hopefully temporary period of excessive cost of capital. And to implement types of what is indeed a wrenching shift of necessity—when you reverse investment tax credit and put it into the corporate tax rates, my judgment is that it is dangerous to do that today. It might be quite desirable at a later date. I think they are mistaken in evaluating the current period.

Dr. **Weidenbaum**. Many of the proponents of the tax reform bill brush aside the negative effects on the economy for the first 5 years. They are focusing on something way out.

Dr. **Roberts**. The basic problem with H.R. 3838 is it raises the marginal tax rates on new investments and uses the proceeds to lower the average tax rate on old investment already in place and on labor income. So you have a terrible incentive effect on new investment; you have no offsetting incentive effects elsewhere. That is the problem with the bill.

Senator **Heinz**. Outside of that, it is a fine bill. Thank you very much.

The **Chairman**. Dr. Greenspan, I am confused about your definition between subsidies and incentives as you were explaining it earlier on. A corporate tax reduction or whatever the corporate tax rate may be is not a subsidy, but an investment tax credit is?

Dr. **Greenspan**. No; let me be very specific. I define a tax subsidy as any aspect of the Tax Code which induces capital investment on an aftertax basis which would not have been initiated on a pretax basis.

The **Chairman**. All right. If we do want to accomplish certain things—you use the defense example—if we do want to accomplish certain things, we ought to do it by appropriations rather than the tax credit?

Dr. **Greenspan**. Yes, sir.

The **Chairman**. So that if we are convinced we would like to maintain the Willard Hotels of the world or restore them, we should do it with the equivalent of a Model Cities Program rather than a historic tax credit?

Dr. **Greenspan**. Yes, sir.

The **Chairman**. Same with health insurance. If we want our people to have it, we should have, in essence, a national-style British health system or something like it by appropriations rather than [Laughter.] The nontaxability of employer-provided health benefits?

Dr. **Greenspan**. You are asking me to acquiesce in a program which I have very great difficulty with to begin with.

The **Chairman**. Well, I am assuming that if employers did not provide it, we would by this stage have had British style or equivalent in national health insurance.

Dr. **Greenspan**. That is a very complex question. As to the principle you are trying to raise, I am saying, yes; I would prefer that it be handled directly. I am not certain that in this particular instance it is that simple. I would have to think about that.

Dr. **Weidenbaum**. That is why tax expenditures should not be viewed as a pejorative term.

The **Chairman**. Well, I do not think they are.

Dr. **Weidenbaum**. And some of them are low-cost alternatives to a direct Federal expenditure.

The **Chairman**. Most of us would say that probably the historic preservation credit is lower cost than the Model Cities Program if what you were trying to do is restore downtown St. Louis or Washington or Portland or Providence or something like that.

Dr. **Weidenbaum**. Yes, sir.

The **Chairman**. Now maybe the program is not worthwhile. Maybe you should not do it at all. That is a fair question. But if you decide you are going to do it, which is the better way to do it.

In my experience, with a few exceptions perhaps, in almost all cases it is probably cheaper to do it, probably more efficient to do it with the Tax Code than with straight-out Government appropriations where we tax you, collect it, disperse it to the regions and it finally dribbles down, hopefully, to where you would like it to be spent.

Dr. **Weidenbaum**. Often using the Tax Code means it is the private sector alternative.

The **Chairman**. That is correct. In almost all cases it is, whereas in the other, with a few exceptions like the old heyday of the reconstruction finance corporations, it is often a government-done concept.

All right. I am glad we agree. And I am glad Alan agrees partially.

Now this bill has one gigantic philosophy. It is a $140 billion shift from individuals to business, with which all of you would disagree, don't like the shift.

As for the other side of the argument: I have been at the meetings of the White House often enough to realize that the President is convinced that tax reform is lower individual rates. Whatever else is necessary to get there is secondary in importance. I take it with that you do not agree.

Dr. **Weidenbaum**. I disagree. I think it is the other way around.

The **Chairman**. Dr. Roberts.

Dr. **Roberts**. Yes; I disagree with that. I think if you raise the cost of capital by changing other provisions more than—and labor, more than you lower it by cutting the individuals rates, then you have not gained anything by cutting the rates. The point of cutting the rates was to get some net gain. And the trouble with the bill is that it does not cut the rates enough to offset the other provisions in the bill such that it is not a net gain.

Dr. **Greenspan**. If the President is indeed saying that, I disagree with him.

The **Chairman**. Pardon me?

Dr. **Greenspan**. I said if the President is indeed saying that, then I would disagree with him.

The **Chairman**. I do not think he is consciously saying it, Dr. Greenspan, but I know in his mind that the goal of lower rates is so paramount that what you have to do to make the bill revenue neutral is a secondary factor in his mind.

Dr. **Weidenbaum**. Why call it tax reform?

The **Chairman**. Why not just call it a tax shift, you mean?

Dr. **Weidenbaum**. Tax cut.

The **Chairman**. That is fair enough. It is.

Dr. **Weidenbaum**. Tax shift; yes, sir.

The **Chairman**. It is a tax shift, and it is a tax cut for some and it is a tax increase for others. And it comes out, hopefully, neutral, hopefully.

Dr. Roberts does not think it even comes out neutral. But we are all hoping that, at worst, it comes out neutral.

There was testimony yesterday with two of the three economists that would agree with Dr. Roberts that it is not even going to be neutral.

Dr. **Weidenbaum**. My calculations show it is not neutral.

The **Chairman**. Senator Grassley.

Senator **Grassley**. There has been very little discussion today about the high cost of perfecting and changing and paying for some of the agreed upon wrongs in the House bill. Understanding that the President has said he would veto a bill that had any new taxes in it, you know, some way money has to be raised to pay for some of this stuff, if there are changes going to be made like for capital formation, what is your assessment in view on various forms of alternative taxes—consumption tax, taxes, value-added tax, business-transfer tax, oil import fee or something like that?

Dr. **Weidenbaum**. My view is negative. I think that is a way of putting aside the most urgent task which is cutting spending.

Senator **Grassley**. But I am not asking the question in light of Gramm-Rudman targets and the necessity of getting the budget deficit under control. I am asking in terms of raising revenue to provide, say, shorter depreciation schedules that are in H.R. 3838 or maintenance of some investment tax credits.

Dr. **Weidenbaum**. Oh, a simple answer is to stay with the current Tax Code, and you would have adequate financing of ACRS and ITC.

Senator **Grassley**. Dr. Roberts.

Dr. **Roberts**. I am not sure the current Tax Code is adequate for us to meet the competitive pressures we face. I recently completed with my colleagues a study of the cost of capital in the United States and Japan, and we find that under the Japanese tax system we would have a substantially lower cost of capital in the United States. Indeed, it is hard to see how we can ever compete with the Japanese given our tax system and given theirs.

So I do not think the current tax system is the answer to our competitive problems. It is true that it is certainly better than H.R. 3838. We would go downhill a lot faster under H.R. 3838.

Now if you wanted to fix this bill, in my view, it is kind of difficult given the confines—the way the whole thing came up and the way it is structured and what the White House is emphasizing. It would be kind of hard to fix it.

In order to fix it, you would have to fundamentally alter it just to fix it. You cannot fix it within its structure, in my view. So you would have to fundamentally alter it.

So since you have got to do that, if you were going to have a tax reform and one keyed toward our trade problems, I would just start over from scratch and not try to fix it.

Senator **Grassley**. Would you raise revenue from a new tax in the process of trying to accomplish that goal?

Dr. **Roberts**. Well, if I did, I would be careful. For example, I would not put on oil import fees because that would raise the cost of producing goods in the United States relative to the rest of the world. And, therefore, it would worsen this competitive problem.

Senator Roth's business transfer tax would be a way of raising revenues that did not directly worsen our existing trade competitiveness position. Not that I am saying we should be raising revenues. But I am saying if you were going to do that, I would be very careful that I didn't pick up a tax that simply was going to worsen the trade position that we are already in.

Senator **Grassley**. Dr. Greenspan.

Dr. **Greenspan**. Anything which would lower income tax rates and raise other tax rates, irrespective of what they are, including the value-added tax, the BTT, oil import tax, would be desirable as a set of alternatives.

The problem with the oil tax is not only the issue that Dr. Roberts raises but there is somehow a peculiar presumption that it is politically easy to do. The argument goes that if the crude oil price falls and you insert the tax before it works its way through the product price gasoline and home heating oil, somehow it is easier to do.

There is almost no way to time such a tax so that the product prices don't fall first. Lower prices then become a seeming property right of the consumer.

The one tax which does not inhibit significantly our competitive position or the cost of doing business is a tax directly on the retail transaction such as a gasoline tax at retail.

All other taxes, one way or another, have negative effects on the economic system. It is only a question of degree. The income tax is clearly the most onerous.

The **Chairman**. Senator Long.

Senator **Long**. Mr. Greenspan, I think I understand your attitude about a tax subsidy compared to a spending subsidy. I would like to discuss that with you for a moment.

Having had some experience in both areas, it seems to me that you ought to look them the way you look at a knife, a fork or a spoon when you sit down at the dinner table. Each serves a purpose, and you pick up the one that serves the purpose best. If you are going to eat liquids, you reach for the spoon. If you are going to cut something, you reach for a knife. If you are going to lift something from the plate, you ordinarily reach for a fork.

In terms of certain things that I would regard as tax subsidies over a long period of time—donations to education, art, museums, things like that—would you regard them as a subsidy?

Dr. **Greenspan**. Senator, I obviously have been involved in a lot of discussions from an administration point of view over the years and making all of these various choices. I must admit that most of my problems are often not on whether or not it is a tax subsidy or an expenditure subsidy but if the program is lousy. And most of the times we often find that some form of tax credit is easier politically to get through than is an expenditure grant or an appropriation.

I do not want to get to the position where I am making a major issue of principle here that I really don't think it is a major issue of principle. I think far more important than either the choice is the program itself. And I must admit in most the instances where these debates arise, I tend to be against the program anyway so it doesn't really get down to the issue of which is which.

Senator **Long**. I just want to make a point for some of the things I have seen subsidized over the years. If you do it by an appropriation, there is a great deal less certainty and much less uniformity.

Some people get it, and some people don't. There is a built-in administrative complexity built that often amounts to discrimination.

If you do it by way of a tax subsidy, generally speaking, everybody gets it. Anybody who wants to involve himself in it can get it. If you do it that way, you have more certainty. To take it away, you have got to repeal or amend that law. If you do it that way, you have more certainty. You don't get a shot at it every year the way you do with an appropriations bill. If you are doing it by way of an appropriation, you can knock it out with a floor amendment to any appropriations bill if you have 51 votes. Then the House may be compelled to go along with it.

Also, when you use tax subsidies for things like homeownership or historic preservation, you avoid having to go to some Federal bureaucrat and make application. The bureaucrat, par for the course, is busy or on leave. You come back tomorrow or next month. You finally get the paper in one office. We hear from constituents: For God sake, see if you cannot get that thing moved over to the Dallas office.

You also have the problem of getting it from the bottom of the stack to the top of the stack. Then you have to argue about whether you or somebody else ought to get the benefit or are told to wait until next year's annual appropriations.

Considering all the problems that are involved, my impression is that if you want somebody to get some benefit, you should do it by way of a tax subsidy. That way he gets it. If you use appropriations, he might get it and, then again, he might not. That has been my experience.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

I want to go back to this remarkable phenomenon of having all the economists agree that the bill before us, the House bill, is bad legislation. But what I would like to point out is that it seems to me clear cut that if we are going to develop the kind of policies that I think are necessary to help create a favorable tax climate for growth and jobs that we have to seek a new source of revenue to use to finance these reforms. Or otherwise we have to back off what the House did. I think they took some steps to improve the treatment of the middle class. But I am unwilling to back off of that as a means of bringing about some of the other reforms.

So I wonder if you would agree with me that we ought to consider some new source of revenue such as the BTT in order to finance the kind of reform that I think is essential. I think we should continue to lower marginal rates as started in 1981. I think we should continue to build programs or savings into the picture and not back off of it. And I think we should continue to provide some better depreciation approaches, and that is what is offered in the House bill.

I wonder if each of you would comment on using the BTT, whether we start from the House bill, or a bill by the chairman or some other approach. What is your reaction to that?

Dr. WEIDENBAUM. I like the idea of taxing consumption rather than income, which is the thrust of a business transfer tax. What worries me, very franky, is making available a new tax source as an attractive candidate to congressional advocates of new spending programs. And I worry after 1991 that we will have a bigger public

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sector with the new tax source than without it. That is the great danger.

Senator ROTH. Let me ask you aside from that problem if you would be in agreement. It is a sound approach.

Dr. WEIDENBAUM. It is an attractive approach, and I think worthy of the committee's consideration.

Senator ROTH. Thank you.

Dr. Roberts.

Dr. ROBERTS. I suppose it might be the safest. I share Murray's concern that it could become an add-on tax that supports more spending rather than what you want to do with it. Maybe it would be safer if you just go after the Tax Code at once with the BTT, and just replace the whole thing with one. And we can end altogether the multiple taxation of saving, tax biases against saving, adverse impacts of marginal tax rates. Maybe that would be the safest way. And then we put in a limit on the share of GNP that can be taken in taxes, and then we would have a pretty good system. We wouldn't have any more tax-caused competitive problems. That is for sure.

Senator ROTH. Dr. Greenspan.

Dr. GREENSPAN. Well, I must say I agree with both of my colleagues. Its just a question of how far you can go in any particular direction. But in the limited form in which you raised your question, it is quite desirable to be looking in that direction because the direction is the right direction. That is, we are overtaxing income. If we insist upon maintaining the level of expenditures, which I must admit I think is much too high, then if we have to raise revenue to do it then clearly BTT or something equivalent is the least worse way.

Senator ROTH. Would it not help us with respect to trade as well? Doesn't it help even the trading field because it is legal under GATT?

Dr. GREENSPAN. Yes; I think it does in part. But I suspect that the movement of the exchange rate will overwhelm any impact that occurs as a consequence of that.

Senator ROTH. Dr. Roberts.

Dr. ROBERTS. I would have to think about this, but I think it probably is neutral with regard to trade. You see, it raises the cost of goods, but it is remitted on exports and applies to imports. So it seems to me it would keep the current competitiveness even. And, therefore, it is one of the few taxes that you could bring up that did not directly worsen.

Dr. GREENSPAN. I think he is talking about substituting that for one that——

Dr. ROBERTS. Oh, if you substitute that for existing taxes on capital source income, yes; it would have a definite improvement in reducing our tax-induced trade disadvantages, which I think are severe.

Senator ROTH. I feel very strongly that it would help. It may be to ultimately——

Dr. ROBERTS. As a substitute.

Senator ROTH. For a time at least where——

Dr. WEIDENBAUM. It would help.

The CHAIRMAN. Senator Symms.

Senator **Symms**. Thank you, Mr. Chairman.

I want to thank these witnesses this morning. I think it has been very enlightening testimony, all three of you.

I would just like to pursue Senator Roth's question and to reemphasize the chairman's problem. If you have the individual rates and corporate rates at the level proposed in Treasury II and exemptions as proposed in Treasury II and assume the State and local tax deductions are going to be maintained, no additional tax on individuals over the amount provided in the House bill, where do they get the dough to do this?

Dr. **Weidenbaum**. Why do you want to do it in the first place?

Senator **Symms**. Well, I don't want to, but I just want to ask a rhetorical question.

Dr. **Weidenbaum**. A business transfer tax would be perhaps the least worse way of getting the financing.

Dr. **Roberts**. I wouldn't want to waste the possibilities of a business transfer tax on trying to fix a no-good bill. That would squander an opportunity. I certainly wouldn't encourage you to use that BBT to try to fix H.R. 3838.

Senator **Symms**. Do you share that, Dr. Greenspan?

Dr. **Greenspan**. I suspect it would be tough. I would be concerned that we would try to solve the problem instead of reversing the extraordinary shift of tax base from individuals to corporations that we will try to, in a sense, make it up somehow. And I think that would be a mistake.

Senator **Symms**. I appreciate that answer. I find myself as one who happens to be in favor of tax simplification and a reform. I am very discouraged with what is presented to us as a choice because we simply—and I agree with what you said, Dr. Roberts—it would be better to do it all and throw the whole code out, and then you don't have the problem that Murray brings up. Because I think that that is a risk.

If we would believe in history, we know that Congress has the ability to spend more money than the revenues. I think we have pretty much proven that point consistently for the past many, many years. It is reaching a crescendo; it is getting worse. But there is a great popular concept in the country that we should have the so-called corporate minimum tax. So we have fairness in the code.

I do not know if the witnesses have focused on this. The witnesses that we had yesterday questioned whether Congress has really focused on what the consequences of this so-called alternate minimum tax in the House bill would be.

Now, to me, to have a 25-percent alternate minimum corporate tax is schizophrenic. It has the effect of eliminating and reducing after-tax value preferences as part of the minimum tax base to the extent that such preferences are utilized by those who become subject to the tax.

In other words, what I am saying is if you are good at figuring out how to use preferences, then you fall under a completely new tax, you lose the benefit of preferences, and your costs are higher because you are better at it than your competitors. So it is kind of a diabolical——

Dr. Roberts. It would get the wrong people. If you want to get the shelters, get the people who have some unplanned reverse in their business transactions—something they didn't expect. That's the people who would get it. It won't get the people that all demagogic——

Senator Symms. Right. But what it will get is the entrepreneur that has tried to start on a new venture.

Dr. Roberts. And has a reverse.

Senator Symms. And has a reverse, and he is nailed.

Dr. Roberts. It will get him.

Dr. Weidenbaum. Also, the basic support for minimum corporate tax is based on a statistical illusion. If there is anything predictable, once a year a tabulation has surfaced in this town showing how many corporations showing very little, very small percentage of their income in Federal income taxes. And a great many of them are multinational corporations that, of course, don't pay much of their income in terms of Federal tax because they pay it to 16 different countries. And the tabulation conveniently forgets the amount of corporate income tax that they pay to the other 15 countries, but they look at the total amount of income of the corporation.

So if you look at the theoretical basis for the minimum tax, I say you are facing a statistical illusion.

Senator Symms. So in other words, that is a bad idea?

Dr. Weidenbaum. Yes, sir.

Senator Symms. And it would be bad for our economy to try to effect it.

Dr. Roberts. Just look what the minimum tax—you put in one in 1982, or rather you didn't put one in but you added to it—and you wiped out the mining industry. You wiped out 60 percent of the profits associated with the then existing level of output. And you didn't know that was going to happen. The staff didn't tell you, Treasury didn't tell you. They didn't even know. But that was the effect.

And the revenue lost from that cutback in employment in terms of payroll taxes and withholding taxes greatly exceeds—it is a multiple of the projected static revenue gains that the minimum tax was supposed to produce.

Senator Symms. Thank you, Mr. Chairman.

The **Chairman.** Senator Durenberger.

Senator Durenberger. Let me ask, Paul, you a question first. You said we should not squander the business transfer tax on a bill we don't like or something. I am on the Superfund conference. Do you know enough about the tax that this committee put on Superfund to get the tax off the oil industry; that you would say that probably was not a smart thing to do to start the process of a general consumption tax on a public works project?

Dr. Roberts. I will have to answer you truthfully. I don't know enough about it to be willing to comment on it.

Senator Durenberger. Murray.

Dr. Weidenbaum. I think that the Senate has a great opportunity to develop a tax not on production, whether it is production of chemicals, oils, or business generally, but to tax the pollution. Because if you put a tax on the pollution, then you reduce the future flow of all that gunk into the future Superfund problem.

And just taxing business generally, you are going to lose a great opportunity to really use the tax system constructively to reduce the future amount of pollution generated.

Senator **Durenberger**. Let me go back to one of the last comments Dr. Greenspan made. He said we are overtaxing income. And it strikes me—if I am trying to get some practical advice on doing what you tell us not to do, which is what we are doing here—I mean it is sort of ridiculous to say what we should be doing when we all know what we are going to be doing. And everybody I think from the questions is trying to get some practical advice.

We are overtaxing income in this country, and I assume that means the combination of the income tax and the payroll tax, right?

Dr. **Greenspan**. Yes.

Dr. **Roberts**. Right.

Senator **Durenberger**. And we don't pay any attention to the payroll tax. It just keeps going up, screwing our kids and so forth, and we are forgetting about that.

And I take it your advice would be that if we are going to do income tax reform, we ought to be looking at it in a larger context of the payroll tax and the income tax. Does anybody disagree with that theory?

[No response.]

Senator **Durenberger**. Then the second part of that is the statement that I think the chairman made when he was quoting the President, which is the importance of rate reduction. If we are overtaxing income, maybe one of the ways to get income tax bases back into balance is to bring the rates down to 15 percent, 25 percent, and 35 percent. And I assume that may be somebody's theory around here. At least that is what we are operating on.

And the way that we have been asked to do that is to trade off base, and the assumption that in the base—and I just show you what I do at home. I take H.R. 3838 and every chance I have with my constituents I say here is how I am going to get you involved in tax reform. This is what we are doing this year; 4½ pounds, 3,980 binds, all that sort of thing.

But that is not important. The important thing is that this is an effort to take Dave Durenberger who is in the 50 percent marginal tax bracket and George Bush who is in the 12½ percent bracket with more income than Dave Durenberger and try to equate them by forcing George up to 25 percent by promising Dave he can come down to 35 percent.

And it is going to be revenue neutral. And all of you folks out there, all you have to do when we get through with this process is decide whether you are Dave or George. And you can be for it or against it. [Laughter.]

Would either of you argue with that as a tax principle. Isn't that the principle of taxation which is guiding us in this reform?

Dr. **Weidenbaum**. I don't know about George. I identify with Dave. [Laughter.]

Senator **Durenberger**. I got that in the newspaper.

Dr. **Weidenbaum**. What worries me is the hit-and-miss basis for making up the revenue loss of reducing the rate table. And if you look at—whether these are investment incentives or any other items I put into my formal prepared statement—it is an act of desperation, I thought on the part of the House to come up with the kind of offsetting changes to pay for——

Senator **Durenberger**. It is just to set up pressing pressure points out here behind you. I mean it is pitting the weakest against the strongest and vice versa. And when we search for principle, you find the House is proconsumption and we over here traditionally are procapital formation, savings and investment. But we can't get there because we can't even take the consumption bias out of the existing Income Tax Code, can we? I mean isn't that one of the places we ought to start?

If we want to be more—we want to be different from the House and less consumption oriented and we are stuck with this scheme of lowering the rate by broadening the base, then wouldn't you say to us in part of the base broadening process, rather than starting with the capital formation start with the consumption stuff. And if you said that, what would you say we start with?

Dr. **Roberts**. Well, you would junk the income tax and have a consumption-based tax. Or if you have an income tax, make it consumption based.

Senator **Durenberger**. But if you are stuck with the income tax, what do you do on the base?

Dr. **Roberts**. You have to make a consumption base income tax. You have to eliminate the bias in the code against saving by exempting saving from the tax base.

Dr. **Weidenbaum**. Craig is referring to an expenditure tax. And there are many examples of how you convert an income tax to an expenditure tax.

Dr. **Roberts**. Just make it a consumption-based income tax.

Senator **Durenberger**. Well, how about the interest reduction, the consumer interest deduction? How about that sort of thing?

The **Chairman**. Time is up.

Dr. **Roberts**. The interest deduction——

Senator **Durenberger**. Can he finish answering the question, Mr. Chairman?

The **Chairman**. Yes; I thought you were moving on to another subject.

Senator **Durenberger**. No, no; I am just trying to finish off the panel.

Dr. **Weidenbaum**. In what way? [Laughter.]

Senator **Durenberger**. I don't find anything to disagree with. I didn't know whether Alan had had a chance to reply to the notion that we ought to be eliminating some of the proconsumption bias.

Dr. **Greenspan**. I definitely agree with that. This is an abstract discussion which is not going to get you very far. But in principle, it is desirable to try to lower the income tax rate structure and absorb it in the base. I don't think that there is a Dave-George issue here.

If somebody enacted H.R. 3838, they would be giving an awful lot of money to me, and I, frankly, think it is a terrible bill nonetheless. So we are not dealing strictly with who gains and who loses. I would gain very significantly from this bill. That doesn't change my viewpoint of what a lousy bill it is as it now stands.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

I have one specific inquiry for Paul Craig Roberts, because, Dr. Roberts, in your testimony, you imply that anything that we can do to expand the pool of pension assets will increase the savings necessary for capital formation.

We talked a lot about what is wrong with the House bill and Treasury II. We haven't much talked about what we might be doing to address the issue of increasing savings in this country, which everybody that I have talked to agrees is too low. And you did touch on that.

Now in 1984, if my memory serves me, a very significant pool of additional savings was created by the growth in pension fund assets. About $130 billion net of distributions. Only about $60 or $65 billion of that I suspect most all of which was probably—at least two-thirds and possibly four-fifths of which was paid back out, if you will, in the way of benefits.

Most of that $130 billion probably came from interest earned, capital gains, and the like, and was added to that even larger pool of savings represented by pension plans. Do all tax-favored savings, which is as one, have the same effect on capital formation or do you see a difference between the effects of long-term savings for retirement and relatively short-term savings in thrift plans? Do you see a difference?

Dr. ROBERTS. Well, I am not exactly sure what you mean by the short-term savings and thrift plans. Do you mean like the temporary savings certificates that they came out with a few years ago?

Senator HEINZ. I am thinking of IRA's, which have a relatively low penalty for withdrawal, 10 percent so after 2 or 3 years, it is pretty attractive to take your money out.

Dr. ROBERTS. Oh. So you are really asking about, does it help to lock it away so you can't get it out?

Senator HEINZ. 401(k) plans which have very low thresholds for distress withdrawals, such as, I want to buy a house.

Dr. ROBERTS. I think in a way it may be that having low penalties for withdrawals makes people feel more comfortable about putting a larger share of their income into retirement plans.

Senator HEINZ. Absolutely correct. I am not asking that question. We had a hearing in this room a couple of days ago where the very point you are making was clearly made.

I am just asking not so much how you get from here to there, just whether savings that is—turns out to be locked up for retirement, is better than savings that turns out not to be locked up for retirement in terms of capital formation.

Dr. ROBERTS. Well, I wouldn't know precisely, but I wouldn't want to assume that locked-up savings would be better because I would think being locked up means people know that if they have some kind of difficulty, they are less protected and therefore they may have two kinds of savings or they may not put as much into savings.

So I don't think there is anything to be gained by locking it up.

Senator HEINZ. You emphasize an appropriate concern, but my question is not so much, should we eliminate, as the Treasury II plan does, savings for purposes other than retirement. You are reading something into my question that isn't there. I oppose the way Treasury II attempts to define legitimate savings only as savings for retirement for many of the reasons I suspect that you do.

But what I am saying is, if you want to mix and you take into account the psychological elements in getting people to participate in plans, on balance, is there not a benefit toward encouraging more in the way of retirement savings as opposed to not encouraging it and setting up vehicles that are nominally for retirement savings and, in fact, just turn out to be a way of gaining the tax system?

Dr. ROBERTS. Yes; yes.

Senator HEINZ. That was really what I meant to ask in the first place, and I think you were thinking I was trying to get you on the side of Treasury II, and I am not. I promise you.

Dr. ROBERT. Yes; I agree.

Senator HEINZ. I do think there is an opportunity here, if we go ahead at some point with tax reform, to strike a few blows for a slightly more rational income and capital formation policy. And one of the things many of us have been saying—and I will be brief, Steve—is that it is not just enough to talk about let's not stick it to capital formation and business savings; how do we increase the savings pool? And that question has been remarkable by its failure to be asked in the last 2 days of hearings. So I thought I had better ask. Maybe there is some other way to do it.

Dr. ROBERTS. You have got to stop the Treasury from this curtailment of private pension plans, which it has been doing—1982, 1983, 1984. It is again in this tax reform proposal. Considering the burdens on Social Security and the payroll tax implications of Social Security, it is particularly irrational to be curtailing the growth of private pensions.

Senator HEINZ. In fairness to my colleagues—Steve Symms has a vote on. I don't want to trespass on his time.

Senator SYMMS. Have you voted yet?

Senator HEINZ. No; I haven't.

Senator SYMMS. I am through asking questions. I just want to thank them all on behalf of the committee, and you go ahead.

Senator HEINZ. Can I ask one quick question, then?

Senator SYMMS. And then we are going to have to recess.

Senator HEINZ. I understand. I will so do.

Dr. Roberts, you also emphasized the importance of the pension contribution and benefit limits in making savings available for capital formation. In the last 2 years, we have not only lowered those limits, we have eliminated indexing, an important point of stability. They have been frozen, as you know, since 1982.

How important is it, in your judgment, that these limits be permanently indexed to price or wage increases?

Dr. ROBERTS. I think they should be indexed.

Senator HEINZ. Is there any disagreement with that?

Dr. WEIDENBAUM. No.

Senator HEINZ. All right.

Gentlemen, our time has expired. There is a vote on the floor.

Dr. **Roberts**. Mr. Chairman, may I submit for the record a corrected version of my testimony? The one I submitted was without——

Senator **Heinz**. Without objection, so ordered.

Gentlemen, you are all deeply appreciated by all of us for returning once again to the Capitol, to these hearing rooms. We thank you for your contributions. The hearing is adjourned.

[Whereupon, at 11:48 a.m., the hearing was concluded.]

[By direction of the chairman, the following communication was made a part of the hearing record:]

TAX REFORM ACTION COALITION
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For Information Contact:
Jerry Rapp (202)342-2052

THE TAX REFORM ACTION COALITION SUBMITS STATEMENT TO FINANCE COMMITTEE IN SUPPORT OF TAX REFORM EMBODYING SUBSTANTIAL REDUCTIONS IN MARGINAL RATES

Washington, D.C. (January 30, 1986) ... The Tax Reform Action Coalition (TRAC), the major business coalition which supported passage of H.R.3838, the Tax Reform Act of 1985, by the House of Representatives submitted a statement for the hearing record to the Senate Finance Committee today. TRAC urged the Committee to promptly report tax reform legislation which substantially reduces nominal tax rates for individuals and corporations to the 35 and 33 percent levels proposed by President Reagan in May, 1985.

TRAC is comprised of some 250 major corporations and business associations (see attached list). Overall, TRAC's members directly represent over 100 of the Fortune 500 industrial companies, the largest wholesale distribution and retailing companies, major financial services and investment companies, oil and real estate interests, and over one million small and mid-sized businesses.

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The Coalition told the Finance Committee that substantial reductions in nominal tax rates like those proposed by the President and those achieved in the House legislation would bring long-term economic benefits and efficiences which cannot be achieved under the current, preference-riddled tax system.

In its statement, TRAC also takes issue with claim that tax reform legislation which reduces rates and broadens the tax base will harm the international competitiveness of domestic corporations by allegedly raising the "cost of capital." The Coalition notes that such arguments ignore two facts. First, they focus solely on physical capital even though the "cost of capital" must be measured by what the user of any type of capital would be willing to pay for it. Second, dramatic rate reductions -- particularly the 33 percent and 35 percent rates which TRAC urges be adopted -- will fundamentally reduce the cost of financial capital which is the debt and the equity that lenders and shareholders provide to corporations.

Overall, TRAC notes that several of its major corporate members who manufacture automobiles, computers, containers and other products "... have concluded that the overall benefits of tax reform will actually enhance their international competitiveness."

Finally, TRAC urges the Senate to end the tax-induced inefficiencies in the American economy by completing the task begun by the House in H.R.3838.

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Food Marketing Institute
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Libbey-Owens-Ford Company
McDonald's Corporation
Merrill Lynch & Company
National Association of Convenience Stores
National Association of Tobacco Distributors
National Association of Wholesaler-Distributors
National Federation of Independent Business
National Mass Retailing Institute
National Retail Merchants Association
National Tire Dealers and Retreaders Association
National Venture Capital Association
Philip Morris Incorporated
Pillsbury Company
Preston Trucking Company
Procter & Gamble Manufacturing Company
Quaker Oats Company
R.J. Reynolds Industries Incorporated
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Standard Oil Company of Ohio
U.S. Tobacco
Wine & Spirits Wholesalers of America
Winn-Dixie Stores Incorporated

(General Membership)

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Air Delivery Service Incorporated
Air Van North American
American Association of Advertising Agencies
American Dental Trade Association
American Federation of Small Business
American Frozen Food Institute
American Jewelry Distributors Association
American Movers Conference
American Traffic Safety Services Association
American Veterinary Distributors Association
Amfac Incorporated
Appliance Parts Distributors Association
Arkansas Freightways
Associated Wire Rope Fabricators
Association of Footwear Distributors
Atkinson Transfer Incorporated
Aviation Distributors & Manufacturers Association
B. F. Fields Moving & Storage
Bass Transportation Company Incorporated
Bearing Specialists Association
Beauty & Barber Supply Institute
Bicycle Wholesale Distributors Association
Biscuit & Cracker Distributors Association
C. W. Transporting
Campbell Soup Company
Cargo Express Company Incorporated
Carlton Trucking Company Incorporated
Carolina Freight Corporation
Carr Truck Service Incorporated
Ceramic Arts Federation International
Ceramic Tile Distributors of America
Chilton Corporation
Columbia Motor Express Incorporated
Contractual Carriers Incorporated
Council for Periodical Distributors Association
Council for Wholesale-Distributors National Kitchen and Bath Association
Craig Transportation Company
Crawford Fitting Company
Criber Truck Leasing Incorporated
Crouse Cartage Company
D. L. Merchant Transport Incorporated
Dart Trucking Company Incorporated
Dayton Hudson Corporation
De Fasio Express Incorporated
Dobson Mover
Door & Hardware Institute
Edmac Trucking Company Incorporated
Electrical-Electronics Materials Distributors Association
Elmer Buchta Trucking Incorporated
Explosive Distributors Association
Farm Equipment Wholesalers Association
Federated Department Stores Incorporated

-more-

General Membership cont'd

Flat Glass Marketing Associaton
Fluid Power Distributors Association
Food Industries Suppliers Association
Friedl Fuel & Cartage Incorporated
General Delivery Incorporated
General Merchandise Distributors Council
Griffin Distributing
Hartford Dispatch & Warehouse Company Incorporated
Health Industry Distributors Association
Hobby Industry Association of America
Independent Medical Distributors Association
Institutional & Service Textile Distributors Association Incorporated
International Sanitary Supply Association
Irrigation Association
Jewelry Industry Distributors Association
K mart Corporation
Kemp Furniture Industries Incorporated
King Transfer Incorporated
King Van & Storage Incorporated
Krenn Truck Lines Incorporated
Lacy's Express Incorporated
Land Trucking Company Incorporated
Larmore Incorporated
Loctite Corporation
Materials Research Corporation
Matterson Associates Incorporated
McCourt Cable Systems
McLauren Trucking Company
McRae's Incorporated
Metal Purchasing
Mid-West Truckers Association
Monument Builders of North America-Wholesale Division
Moore & Son Trucking
Music Distributors Association
National American Wholesale Grocers Association
National Appliance Parts Suppliers Association
National Association for Hose & Accessories Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Marine Services
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Plumbing-Heating-Cooling Contractors
National Association of Retail Druggists
National Association of Service Merchandising
National Association of Solar Contractors
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Distributors
National Association of Writing Instrument Distributors
National Automotive Radiator Service Association
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Associaton
National Fastener Distributors Association
National Food Brokers Association
National Food Distributors Association
National Food Processors Association
National Frozen Food Association
National Industrial Belting Association
National Industrial Distributors Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmith Suppliers Association
National Marine Distributors Association
National Moving & Storage
National Paint Distributors
National Paper Trade Association
National Plastercraft Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Screw Machine Products Association
National Spa & Pool Institute
National Transportation Incorporated
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
North American Heating & Airconditioning Wholesalers
Odisco Transportation
Optical Laboratories Association
Outdoor Power Equipment Distributors Association
PACCAR Incorporated
Pace Maker Express Incorporated
Pet Industry Distributors Association
Polar Transport Incorporated
Power Transmission Distributors Association
Priority Freight System Incorporated
Red Star Truck Lines
Safety Equipment Distributors Association
Safeway Stores Incorporated
Scaffold Industry Association
Shared Medical Systems
Shoe Service Institute of America
South Hills Movers Incorporated
Southern Industrial Distributors Association
Spring Service Association
Textile Care Allied Trades Association
The Maxwell Company
Tomahawk Services Incorporated
Toy Wholesalers' Association of America
Unifi Incorporated
United Pesticide Formulators and Distributors Association
W. H. Fitzgerald Incorporated
Wales Transportation Incorporated
Walgreen Company
Wallack Freight Lines Incorporated
Wallcovering Distributors Association
Ward Transport Incorporated
Ward Trucking Incorporated
Warehouse Distributors Association for Leisure & Mobile Products
Warren Trucking Company
Water & Sewer Distributors Association
Wheeler Transport Service
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association
Wilcox Trucking
Wood Heating Alliance
Zayre Corporation

January 1986

TAX REFORM ACTION COALITION
1725 K STREET, N.W., WASHINGTON, D.C. 20006 • (202) 872-0885

STATEMENT OF
THE TAX REFORM ACTION COALITION
SUBMITTED TO
THE COMMITTEE ON FINANCE
UNITED STATES SENATE

"H.R. 3838, The Tax Reform Act of 1985"

January 30, 1986

Introduction

The Tax Reform Action Coalition is submitting this statement to the Committee to express the strong support of our member companies and associations for fundamental reform of the income tax which is based on substantial reductions in nominal tax rates.

Specifically, we urge that tax rate schedules for corporations and for non-corporate businesses be adopted using rates which are no higher than those proposed by the President in his recommendations to Congress in May 1985.

We urge the Committee to take prompt action to report legislation which achieves these objectives.

I. The Members Of The Coalition

The Tax Reform Action Coalition (TRAC) was formed in June 1985 by business associations and corporations which are committed to enacting federal tax reform legislation which substantially reduces the existing high nominal tax rates.

The approximately 250 members of TRAC (see Attachment A) represent a wide range of manufacturing, service sector and other businesses. Overall, TRAC's corporate and association members directly represent more than 100 of the FORTUNE 500 industrial companies, the largest wholesale-distribution and retailing companies, the largest trucking companies, major financial services and investment companies, and over one million mid-sized and small businesses across the country which support federal income tax reform.

TRAC actively supported adoption by the House of Representatives of H.R. 3838, the Tax Reform Act of 1985, as a substantial improvement over current law.

II. Recommendations

TRAC makes two specific recommendations concerning the development of a tax reform package.

> 1. Legislation which reduces top corporate and individual tax rates to at least 33% and 35% respectively, as proposed by the President, should be the primary objective of the Committee's tax reform markup. As adopted by the House, the rate reductions in H.R. 3838 take a significant and historic step toward this objective. We urge the Senate to take the necessary second step by adopting tax rates which are no higher than the President's proposals, and preferrably are even lower as proposed in other Senate legislation.

2. The economic benefits to be derived from significant rate reductions for corporations and individuals are too significant to be delayed or phased-in. Rate reductions should be accomplished in one step and made effective as of the general effective date of the bill.

III. Benefits Of Substantial Rate Reductions

A. Long-term Economic Benefit

Major long-term benefits for the general economy will be derived from substantial tax rate reductions. This fact makes prompt enactment of those reductions an imperative. As noted by 13 of America's most distinguished economists (see Attachment B) in their letter to the House Ways and Means Committee last November, "the most powerful and efficient incentives are market forces, not tax provisions. By far the most productive 'tax incentive' would be to have the lowest possible rates."

The overall long-term economic benefit of substantial tax rate reductions will be a parallel reduction in the impact which the heavy hand of high rates has on the millions of business and personal financial decisions which are made each day. The rate of tax which a person expects will be imposed on the income from making additional investments or from providing more hours of personal labor certainly affects his or her willingness to do that which is otherwise economically sound.

This effect may be so direct and strong as to lead the individual or the business manager to forego doing something because the benefit no longer outweighs the combination of time, resources and taxes which it will cost. Or, more likely, the taxpayer seeks to lessen the tax bite on work and investments by taking actions which do not make sense otherwise. "Tax shelters" for individuals and lease financing subsidaries for many corporations are examples of perfectly rational responses to high tax rates on individuals and corporations.

The inefficiencies of such tax-motivated transactions are apparent. The repeated news reports of overbuilt and underutilized commercial buildings, the pages of newspaper advertisements shouting "TAX SHELTERS!," the proliferation of professionals who earn substantial incomes from legal tax avoidance planning -- all of these are examples of the impact of high tax rates. These economic inefficiencies should be attacked directly and fundamentally by reducing high tax rates, as well as through the traditional "loophole closing" amendments.

Despite the early predictions that the entire tax reform process would collapse in 1985, legislation is now well on its way. One reason is the broadly-based support within American business, based on the benefits of substantial tax rate reductions. Notwithstanding the steady drumbeat of complaints about tax reform, there are numerous large corporations and hundreds of thousands of smaller companies which contribute to the growth of the economy and which would not only benefit directly and substantially from a significant reduction in rates in conjunction with various tax reforms, but which are also united in the conviction that a major reduction in rates is in the best long range interest of our economy.

TRAC recognizes that rate reductions are not a cure for all ills. But we firmly believe that the effect of rate-reducing tax reform on the overall American economy -- namely, the loosening of the tax law's grip on marketplace decisions -- must be the priority objective for tax reform legislation this year.

B. Reducing The Existing Preference For Corporations To Use Debt Financing Over New Equity Capital

The income tax allows a corporation to deduct its interest expense for debt, whether in the form of publicly traded bonds or bank loans, while imposing a double tax on the dividends which are income to the equity investors. The result is to create a clear economic preference by the corporation for debt rather than equity, assuming other factors do not affect the decision.

For example, the corporation which is considered by lenders and equity markets alike to be a quality risk could choose to seek new capital either through additional debt or through a new offering of stock. Assume interest costs would be 10% a year, while dividend payouts would be about 7% of new equity proceeds. Interest is deductible, so the after-tax cost of debt to the corporation would be 5.4% per year. The non-deductible dividends would cost a full 7% in after-tax dollars.

Heavy reliance on debt financing can pose major problems. The inability to service debt can lead directly to seeking protection in bankruptcy and/or to total financial collapse. From certain economic perspectives, such corporate borrowing also contributes to overall interest rate pressures as businesses, individuals and governments compete for funds.

Whatever the merits of particular economic theories about interest rates, there appears to be no argument that the income tax system promotes the use of debt and penalizes equity financing. A reduction in the top corporate tax rate to 33% or less would be an efficient means for lessening the tax-induced preference for debt financing for two reasons. First, when the tax rate is reduced from 46% to 33%, the after-tax cost of interest payments rises from 54 cents on the dollar to 67 cents on the dollar. At the same time, the corporation's after-tax earnings from which dividends are paid are increased as the tax rate falls. To the extent that the corporate tax is actually a tax on profits which the shareholders own, a reduction in that tax should allow for a higher return to shareholders through increased dividends over time.

Thus, the gap between the higher cost of equity and the lower cost of debt is narrowed by the simple act of a substantial reduction of the tax rate. Arguably, this could lead to either lower interest rates (if demand for debt were lessened) or increased dividends (as after-tax earnings increased) or some mix of the two, depending upon one's view of economic theories. But at least one result should be clear. A substantial rate reduction can do much to lessen the artifically, tax-induced preference for debt over equity financing.

C. Reducing Double Taxation On Corporate Dividends Paid To Shareholders

The corporate income tax imposes one level of taxation on the income of a corporation when it is earned, and the individual income tax is imposed on such income when it is distributed as dividends to the individual shareholders. (For a corporation which reinvests its earnings without paying dividends, those earnings tend to be realized as capital gains when shareholders sell stock. While the level of double taxation is delayed and reduced in such situations, it is not eliminated.)

The double-tax structure creates a disincentive for investments in corporations, relative to many non-corporate investments. A limited partnership which owns real estate or other assets can be a much more attractive investment opportunity (as well as a tax shelter) than a corporation because only one level of taxation is imposed on the business's earnings. Money market funds and savings accounts also produce investment income which is taxable only once.

Within the corporate community, the double-tax structure produces disparate results. Growth-oriented companies which tend to reinvest all of their earnings are less penalized for two reasons: (i) the double tax will generally be imposed at a more distant time when stock is sold, and (ii) the double-tax generally will be lessened, due to the lower rate of tax on long-term capital gains attributable to the appreciation in value of reinvested earnings.

However, the more mature companies which tend to pay out a significant portion of their earnings as dividends are penalized more because the double tax is imposed annually and the total tax is higher because dividends are taxable as ordinary income to the shareholder, rather than as capital gains.

Domestic double taxation also tends to penalize American corporations in contrast to certain foreign corporations. Other major industrialized companies allow some form of relief through partial or total integration of corporate and shareholder taxes. To the extent that potential shareholders are willing and able to choose between investing in corporations in the U.S. and other countries, the double tax burden can be a negative factor for the domestic corporation.

A corporate rate reduction is not a substitute for a direct means to reduce or eliminate double taxation. However, a lower rate would at least reduce the extra layer of taxation on income from investments in corporations. This can lessen the artificially tax-induced incentive to invest in non-corporate entities in general, while also lowering the cost to corporations which attract equity investors with significant dividend payments.

D. The Effects Of Rate-reducing Tax Reform On U.S. Companies' Competitiveness

Much has been made of the allegation that tax reform which reduces tax rates while curtailing other provisions of current law affecting investments in plant and equipment will harm

American competitiveness in international trade. This concern has been expressed in two areas -- (i) U.S. companies will be induced to locate plants offshore in order to receive better foreign cost recovery treatment than is currently proposed for the U.S., and (ii) U.S. companies will be less able to compete in foreign markets because the proposed changes to cost recovery and foreign income rules will adversely affect their overall costs.

TRAC does not express a view with respect to any particular provision of either the President's package or H.R. 3838, other than rates. However, our members are distressed to observe the lack of consideration given to the overall impact of a tax reform package on the American economy. Narrowly focused attention on specific proposals can be helpful, but the larger economic impact deserves primary attention.

TRAC urges the Committee to consider these factors.

1. Tax Reform's Effects On The "Cost Of Capital." Critics of the President's package and of H.R. 3838 are quick to highlight computations labelled "cost of capital" analyses and to charge that tax reform will raise the cost of capital for businesses because of the changes in depreciation and the repeal of the investment tax credit. As a result, it is alleged, American businesses will relocate manufacturing facilities offshore.

Two facts are ignored by this analysis. First, the computations do not present a full cost of capital analysis; rather, they are limited to the cost of physical capital. In other words, the computations deal only with the tax effects of buying plant and equipment. The overall cost of capital must include the measurement of what a user of any type of capital asset -- including debt and equity funds, as well as plant and equipment -- would be willing to pay for it, given the income he expects to receive while holding that property. Therefore, the company which owns plant and equipment has an overall cost of capital which includes what it must pay for financial capital (debt and equity) which it uses to acquire its physical capital (plant and equipment).

Second, the dramatic rate reductions on which tax reform is based -- particularly the 33% and 35% corporate and noncorporate rates which TRAC urges be adopted -- will very substantially reduce the cost of financial capital. Lower tax rates reduce what is often called the "wedge" between what the investor requires as an after-tax return and the amount which his assets (whether physical or financial) must earn before tax. This pre-tax return is the true cost of capital. While such computations are obviously more difficult to make than the precise present value calculations involving depreciation and the investment tax credit, the effects of lower tax rates on the pre-tax returns demanded by shareholders and creditors will offset much -- and in many cases probably all -- of the effects of changes in cost recovery.

Therefore, to conclude that a possibly higher cost of physical capital will drive U.S. factories offshore is to make a judgment based on the most adverse provisions of tax reform.

Manufacturers which decry the corporate tax increases in tax reform legislation include many who have correctly pointed out that "corporations don't pay taxes, people do." When assessing the impact of tax reform on American competitiveness, they should be willing to include the effects of tax reform on the people who contribute substantially to that competitiveness -- employees, shareholders, bondholders, and consumers. When this is considered, we believe that the case cannot be made that tax reform is an overall detriment to manufacturing activities located in this country.

2. Tax Reform's Effects On Domestic Economic Efficiencies. Another shortcoming in the supposition that tax reform will tend to force manufacturing offshore is the failure to consider the effects of both lower tax rates and other provisions in directing more resources to productive investments in domestic manufacturing as well as other industries. A strong growth industry over the last decade or more has been the development of tax shelter expertise among lawyers, accountants, professional syndicators and others who openly develop and promote "investments" based on tax benefits alone. These tax-induced "investment" opportunities are accompanied by the economically bizarre projection of when the venture will turn profitable, so the investor can determine when to bail out!

The combination of significantly lower tax rates for both corporations and individuals, along with a reduction in the tax benefits of such "investments," can have significant advantages for American businesses. As tax-induced shelter investments are made less attractive under both lower rates and reduced benefits, and as productive corporations are made more attractive through lower rates of tax on the corporation itself and on shareholder dividends, new funds should begin to flow to domestic companies.

Several of TRAC's major corporate members who manufacture automobiles, computers, containers, and other products have concluded that the overall benefits of tax reform will actually enhance their international competitiveness.

For these reasons, TRAC urges the Committee to consider the impact of tax reform legislation on the entire economy when assessing the international competitiveness argument.

IV. Conclusion

TRAC is strongly committed to supporting a major tax reform effort based on substantial rate reductions. For far too long, the income tax has driven business managers, investors and consumers alike to alter behavior in attempts to avoid high tax rates. It is now time to reduce the tax-induced inefficiencies in our economy. The principal means to that end is the substantial reduction in tax rates proposed as the centerpiece of the President's tax reform package and included in large part in H.R. 3838.

Reductions in tax rates will result in long-term benefits for the efficiency with which our economy functions and the rate at which it grows. The President has placed critical importance on substantially lower rates, and the House has provided a dramatic and politically difficult -- albeit a partial -- response. TRAC urges the Senate to complete the task.

ATTACHMENT A

TAX REFORM ACTION COALITION
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MEMBERSHIP ROSTER

(Steering Committee)

Allied Corporation
American Apparel Manufacturers Association
American Bakers Association
American Can Company
American Electronics Association
American Home Products Corporation
American Retail Federation
American Trucking Associations
Amway Corporation
Beatrice Companies Incorporated
Beneficial Management Corporation of America
Cadillac Fairview U.S., Incorporated
The Clorox Company
Coalition to Reduce High Effective Tax Rates
Computer & Business Equipment Manufacturers Association
Consolidated Freightways Incorporated
Cyclops Corporation
Dart & Kraft, Inc.
Digital Equipment Corporation
Dominion Resources
Emerson Electric Company
Federation of American Hospitals
Food Marketing Institute
Foodservice and Lodging Institute
General Mills Incorporated
General Motors Corporation
Grocery Manufacturers of America
Hershey Foods Corporation
Hewlett-Packard Company
Hospital Corporation of America
I B M Corporation
Levi Strauss & Company
Libbey-Owens-Ford Company
McDonald's Corporation
Merrill Lynch & Company
National Association of Convenience Stores
National Association of Tobacco Distributors
National Association of Wholesaler-Distributors
National Federation of Independent Business
National Mass Retailing Institute
National Retail Merchants Association
National Tire Dealers and Retreaders Association
National Venture Capital Association
Philip Morris Incorporated
Pillsbury Company
Preston Trucking Company
Procter & Gamble Manufacturing Company
Quaker Oats Company
R.J. Reynolds Industries Incorporated
Ralston Purina Company
Standard Oil Company of Ohio
U.S. Tobacco
Wine & Spirits Wholesalers of America
Winn-Dixie Stores Incorporated

(General Membership)

Air Conditioning & Refrigeration Wholesalers
Air Delivery Service Incorporated
Air Van North American
American Association of Advertising Agencies
American Dental Trade Association
American Federation of Small Business
American Frozen Food Institute
American Jewelry Distributors Association
American Movers Conference
American Traffic Safety Services Association
American Veterinary Distributors Association
Amfac Incorporated
Appliance Parts Distributors Association
Arkansas Freightways
Associated Wire Rope Fabricators
Association of Footwear Distributors
Atkinson Transfer Incorporated
Aviation Distributors & Manufacturers Association
B. F. Fields Moving & Storage
Pace Transportation Company Incorporated
Bearing Specialists Association
Beauty & Barber Supply Institute
Bicycle Wholesale Distributors Association
Biscuit & Cracker Distributors Association
C. W. Transporting
Campbell Soup Company
Cargo Express Company Incorporated
Carlton Trucking Company Incorporated
Carolina Freight Corporation
Carr Truck Service Incorporated
Ceramic Arts Federation International
Ceramic Tile Distributors of America
Chilton Corporation
Columbia Motor Express Incorporated
Contractual Carriers Incorporated
Council for Periodical Distributors Association
Council for Wholesale-Distributors National Kitchen and Bath Association
Craig Transportation Company
Crawford Fitting Company
Criber Truck Leasing Incorporated
Crouse Cartage Company
D. L. Merchant Transport Incorporated
Dart Trucking Company Incorporated
Dayton Hudson Corporation
De Fazio Express Incorporated
Duhamn Mover
Door & Hardware Institute
Edmac Trucking Company Incorporated
Electrical-Electronics Materials Distributors Association
Elmer Buchta Trucking Incorporated
Explosive Distributors Association
Farm Equipment Wholesalers Association
Federated Department Stores Incorporated

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General Membership cont'd

Flat Glass Marketing Associaton
Fluid Power Distributors Association
Food Industries Suppliers Association
Friedl Fuel & Cartage Incorporated
General Delivery Incorporated
General Merchandise Distributors Council
Griffin Distributing
Hartford Dispatch & Warehouse Company Incorporated
Health Industry Distributors Association
Hobby Industry Association of America
Independent Medical Distributors Association
Institutional & Service Textile Distributors
  Association Incorporated
International Sanitary Supply Association
Irrigation Association
Jewelry Industry Distributors Association
K mart Corporation
Kemp Furniture Industries Incorporated
King Transfer Incorporated
King Van & Storage Incorporated
Krenn Truck Lines Incorporated
Lacy's Express Incorporated
Land Trucking Company Incorporated
Larmore Incorporated
Loctite Corporation
Materials Research Corporation
Matterson Associates Incorporated
McCourt Cable Systems
McLauren Trucking Company
McRae's Incorporated
Metal Purchasing
Mid-West Truckers Association
Monument Builders of North America-Wholesale Division
Moore & Son Trucking
Music Distributors Association
National American Wholesale Grocers Association
National Appliance Parts Suppliers Association
National Association for Hose & Accessories
  Distributors
National Association of Container Distributors
National Association of Decorative Fabric
  Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Marine Services
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Plumbing-Heating-Cooling
  Contractors
National Association of Retail Druggists
National Association of Service Merchandising
National Association of Solar Contractors
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Distributors
National Association of Writing Instrument Distributors
National Automotive Radiator Service Association
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
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National Transportation Incorporated
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National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
North American Heating & Airconditioning Wholesalers
Odisco Transportation
Optical Laboratories Association
Outdoor Power Equipment Distributors Association
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Pace Maker Express Incorporated
Pet Industry Distributors Association
Polar Transport Incorporated
Power Transmission Distributors Association
Priority Freight System Incorporated
Red Star Truck Lines
Safety Equipment Distributors Association
Safeway Stores Incorporated
Scaffold Industry Association
Shared Medical Systems
Shoe Service Institute of America
South Hills Movers Incorporated
Southern Industrial Distributors Association
Spring Service Association
Textile Care Allied Trades Association
The Maxwell Company
Tomahawk Services Incorporated
Toy Wholesalers' Association of America
Unifi Incorporated
United Pesticide Formulators and Distributors
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Wales Transportation Incorporated
Walgreen Company
Walleck Freight Lines Incorporated
Wallcovering Distributors Association
Ward Transport Incorporated
Ward Trucking Incorporated
Warehouse Distributors Association for Leisure &
  Mobile Products
Warren Trucking Company
Water & Sewer Distributors Association
Wheeler Transport Service
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association
Wilcox Trucking
Wood Heating Alliance
Zayre Corporation

January 1986

ATTACHMENT B

November 18, 1985

The Honorable Dan Rostenkowski, Chairman;
Members of the Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman and Members of the Committee:

The historic opportunity to accomplish meaningful tax reform now before Congress should not be allowed to slip away. When President Reagan and you, Mr. Chairman, committed yourselves to reform of the tax system, you did so in the name of economic efficiency and fairness, principles that we have long advocated and worked to refine. Those principles are best achieved by lowering tax rates and broadening the tax base without sacrificing revenue. These goals must be reasserted now before the tax reform process becomes just another political struggle to determine who pays and who escapes taxation.

All of the distortions, inequities, ambiguities, and compliance problems associated with an income tax are exaggerated by high rates. The most important issue facing the Ways and Means Committee in the next few critical weeks is whether tax rates can be held down close to the levels proposed by the President.

Although some others have argued that high rates are desirable because they make tax incentives more valuable, we believe that the most powerful and efficient incentives are market forces, not tax provisions. By far the most productive "tax incentive" would be to have the lowest possible rates.

To cut rates without reducing revenue, we must substantially broaden the tax base. Our constricted tax base has caused high-productivity investments in heavily taxed activities to lose out to low-productivity investments in tax favored activities. It has also prompted many companies to reorganize and enter lines of business that they would never consider otherwise. It has diverted valuable attention and resources from innovation and careful management to tax planning.

Base broadening requires the accurate measurement of income. That goal can be achieved only if Congress adopts a realistic depreciation system related to actual depreciation experience of tangible assets. The Committee should terminate the investment tax credit and other provisions that direct capital into activities that cannot survive the test of market profitability. The short-run stimulus for which these provisions were designed should now be traded for a more balanced long-run strategy for sustained economic growth based on low tax rates.

November 18, 1985
Honorable Dan Rostenkowski;
Members of the Committee on Ways and Means
Page 2

The process of reforming the Nation's income tax laws is at a critical stage. The line must be drawn now in favor of low rates and a broad based system. If the Ways and Means Committee cannot accomplish this in the next few weeks, it will have lost the historic opportunity that is within its grasp.

Yours sincerely,

Charles R. Hulten

Charles R. Hulten
Professor and Chairman
Department of Economics
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Brookings Institution

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E. Cary Brown

E. Cary Brown
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Alan J Auerbach

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November 18, 1985
Honorable Dan Rostenkowski;
Members of the Committee on Ways and Means
Page 3

Robert E Lucas
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University of Chicago

George Break
George Break
Professor of Economics
University of California, Berkeley